Exhibit 24

Empowered lives.
Resilient nations.

Palestinian Public Finance Under Crisis Management: *Restoring Fiscal Sustainability*

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Acronyms and Abbreviations

AHLC	Ad Hoc Liaison Committee
CAR	Capital Adequacy Ratio
DARP	Development Assistance Reform Platform
DFG	De Facto Government
EIB	European Investment Bank
EU	European Union
GOI	Government of Israel
GDP	Gross Domestic Product
GNC	Government of National Consensus
GNDI	Gross National Disposable Income
IFIs	International Financial Institutions
IPE	Initiative for the Palestinian Economy
IMF	International Monetary Fund
MOF	Ministry of Finance
MOPAD	Ministry of Planning and Administrative Development
ODA	Official Development Assistance
OECD	Organization of Economic Cooperation and Development
PP	Paris Protocol
PFI	Public Financial Management
PMA	Palestinian Monetary Authority
PNA	Palestinian National Authority
PCBS	Palestinian Central Bureau of Statistics
SME	Small and Medium Enterprises
TFP	Total Factor Productivity
VAT	Value Added Tax

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Executive summary

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Over the last twenty years of the peace process, Palestinian National Authority (PNA) public finance has been going from crisis to crisis with some deterioration in public services, large recurrent budget deficits and virtually no public investment. The PNA succeeded in managing substantial reductions in the budget deficits since 2009, but this process has been accompanied by a sharp decline in economic growth and by rising unemployment. Unfinanced gaps have become a common feature of Palestinian budgets, with occasional interruptions of salary payments, depletion of the Pension Fund and a large accumulation of payment arrears to the private sector. Given that arrears are used as a source of residual financing, the Budget does not fully reflect the fiscal reality. The deterioration in public financial management, coupled with declining external budget support has not been addressed by forceful fiscal policy or by donor support. The devastating war in Gaza and the withholding of Palestinian tax revenue by Israel will only add to the government's financial burdens. Palestinian public finance has become the government's Achilles heel and poses a major risk to its sustainability.

Some Palestinian voices counter that the economy is hamstrung by the restrictions imposed by Israel on movement of goods and people, access to markets and on imports of capital goods, which reduce economic growth, public revenue, and raise the budget deficit. Consequently, the donor community should be paying the full bill for the occupation since it is unable and unwilling to exert enough political pressure on Israel to roll back the occupation. Nevertheless, donor financing is unlikely to increase under the existing aid and political framework. Nor is the roll back of the extensive restrictions on Palestinian economic activity on the horizon. Indeed, the peace process may take several more years before a sovereign Palestinian State is established. While the budget deficit may be largely due to the economic restrictions imposed by Israel, the deficit can be partially reduced through concerted policy actions under government control. This would also allow the government to improve the quality of service delivery, particularly education and health and strengthen its legitimacy with the Palestinian public and its relations with the international community.

However, with the decline in both public and private investment, and with the fall in external assistance and private transfers, the fiscal deficit has become the only engine of economic growth in Palestine. Reducing it triggers a downward spiral of lower growth, and lower revenues, making it that much harder to reduce the deficit further, a self-defeating process. The contractionary impact on the economy of withdrawing the fiscal stimulus by reducing budget deficits, without compensating increases in investment or external transfers, has been compounded by a second contractionary factor: the yearly transfer of Palestinian savings abroad for lack of investment opportunities at home. The large buildup of Palestinian assets abroad stands in sharp contrast to the decline of productive investment at home.

These two domestic factors--the reduction in the recurrent budget deficits and the transfer of savings abroad--largely contributed to the decline in economic growth in the West Bank from double digit

levels in 2007-08 to stagnation in 2013 and 2014. Yet, even in this negative environment, fiscal sustainability can be restored, provided it is accompanied by a sharp increase in public investment and development spending which would offset the negative impact on economic growth of further reducing the recurrent budget deficit. Financing by the donor community of the shift in public spending, under a comprehensive reform program, from recurrent charges to capital formation-a position which they have long advocated- should be complemented by Israeli facilitation of public investment in the West Bank, and in Gaza, by lifting the siege and providing greater access to markets.

Regaining fiscal sustainability would require policy actions towards revenue mobilization and expenditure restraint. Revenue performance has deteriorated by several percentage points when measured against GDP. This was not the result of deterioration in tax administration or tax policy. Rather, Gaza dropped out of the tax net due to the Israeli siege and there has been a significant shift in West Bank economic activities towards low tax compliance activities. Sectors which were most tax compliant, such as manufacturing, suffered most from Israeli economic restrictions and their GDP shares declined, while those which are least tax compliant-- retail trade, construction and services--suffered least from restrictions and their shares in GDP increased substantially.

Resumption of fuel and other imports from Israel to Gaza will restore some of the indirect tax revenue lost since 2007 and a major registration drive of potential taxpayers in the West Bank should increase domestic revenues. However, this drive, only recently launched, will take time and additional staff, before it can yield results. By contrast, a quick revenue yielding action would reduce the differential between Israeli and Palestinian fuel prices. Adjusting fees and charges which have not been increased in a decade would also reduce the deficit.

Consumption taxes account for 92% of Palestinian tax revenue. A family living on the minimum wage is paying 18-16% on everything they consume (except for fruits and vegetables) including basic foods such as milk, bread, eggs, and meat, while the upper income groups pay a much smaller share of their income on consumption taxes. Given the very regressive tax structure in the Palestinian economy, and the need to reduce the recurrent deficit, the authorities may want to consider raising the corporate income tax rate from 20 to 25%.

On the expenditure side, the Ministry of Finance (MoF) succeeded in reducing the PNA wage bill from 23% of GDP in 2007 to 16% of GDP in 2014, a major achievement. Nevertheless, more needs to be done, considering a widespread perception of over-employment in both civil service and security personnel. In the context of a draft law prepared in 2014 for civil service reform, the government may want reintegrate public employees in Gaza into the civil service by merging the two administrations, without raising public employment significantly above the mid-2007 adjusted level. In this respect the government may want to revive a proposal made in 2012 of offering early retirement to about 20,000 employees at half salary or by providing lump sum severance packages. Such a reform, which would treat West Bank and Gaza employees equally, would merit donor financing. Spending on security is

disproportionate relative to spending in neighbouring countries and expenditures on social areas. It should be reconsidered given the need to reduce the fiscal deficit and improve income distribution.

The electricity subsidy to municipalities, refugee camps, and Gaza, is extremely expensive and unsustainable. While it has been reduced substantially between 2007 and 2011, it has increased again since 2012, reaching NIS 1.7 billion in 2014 and costing the equivalent of 3.8 % of GDP. It is partly tied up with Treasury payments arrears to municipalities and the inability to collect electricity bills from Gaza. Reviving economic activity in Gaza and establishing an effective governance structure, should go a long way in collecting these electricity bills. Breaking away from the perennial MoF liquidity shortage and transferring to municipalities their tax shares is part and parcel of restoring fiscal accountability for municipalities. But MoF can only do this if it clears all arrears, as discussed below, improves its financial management, and balances its budget within available financial resources. Unless all issues are addressed together, no individual measure is likely to succeed.

With concerted action on both the revenue and expenditure fronts along the lines suggested above, the government should be able to cover its financing gap over the next 2-3 years. However it should be emphasized that the main purpose of adopting these measures, is not only restoring fiscal sustainability to the Palestinian government, but fundamentally, addressing long standing structural fault lines in Palestinian public finance, and recasting public taxation and expenditure policy in line with international best practice.

The financial stress associated with trying to make ends meet, at least on paper, and without effective corrective measures, was accompanied by deterioration in public financial management: revenue projections in budget preparation have been overstated and expenditures have been understated. Budgetary outcomes have been diverging from the original budgets by as much as one third and linkages between development spending in the budget and the Development Plan have been tenuous. Instead of requesting supplementary budgets to address arrears and cover unfinanced gaps, as was the case in 2009 and 2012, the fall back position has been to let payment arrears to the private sector accumulate in an ad hoc manner, which is opaque, inefficient and inequitable. Restoring sound financial management, by establishing a full accounting of the stock of arrears and outlining a credible repayment schedule would go a long way in recovering credibility with the private sector and salvaging public institutions which have borne the brunt of payment arrears such as municipalities, West Bank and Jerusalem hospitals, universities and the Jerusalem Electricity Company (JEDCO).

Development plans in Palestine have been typically drawn under optimistic economic and political assumptions which did not materialize, taking away much of their relevance in establishing sound, data driven decision making. Plans need to be recast into a realistic economic and financial environment under status quo assumptions. They need to ensure that ongoing projects are completed, identify high priority projects which can be executed under existing political and economic conditions, and fully integrate expected disbursements and financing of all projects into the annual budgets.

Provided the 2015 emergency budget and the 2016-17 budgets are prepared under sound financial management criteria, and adequately supported by policy measures and donor financing, fiscal sustainability could be restored. However, by realigning the recurrent deficit (12.1 % of GDP in 2014) with expected external budget support (8% of GDP), a withdrawal from the income stream of a fiscal stimulus equivalent to 4.1 % of GDP would unfold. This may further reduce economic growth into negative territory. Here, the international community would have to step in and play a key role in supporting the government in its fiscal reforms, committing to the necessary budget support and offsetting the negative impact on growth of reducing the recurrent deficit by financing higher capital formation and development.

In addition to PFM reforms outlined above and in section 7, three recommendations stand out:

- The recurrent fiscal deficit needs to be reduced to the level of available external budget support and bank financing. Revenue and expenditure measures would need to be adopted to achieve this objective, which is essential to avoid accumulation of private sector payment arrears.
- In support of the PFM reforms and fiscal retrenchment, the international community should raise its financing of development and public investment, so as to offset the negative impact on economic growth resulting from the withdrawal of fiscal stimulus through recurrent deficit reduction.
- The international community should deepen its engagement with the PNA in promoting reforms while at the same time firmly committing to agreed external budget support with the PNA. This would be achieved through better donor aid coordination.

Strengthening Palestinian infrastructure and productive capacity, starting with projects listed in the Initiative for the Palestinian Economy (IPE), would send a positive signal to the private sector and encourage their own investments. Israeli support would be essential in largely lifting the siege from Gaza and facilitating the implementation of public investment projects, such as the Gaza Marine, the electricity sub-stations in the West Bank and the water desalination project in Gaza. Developing a critical mass of infrastructure projects and cheaper energy will change perceptions and encourage the private sector to invest, stimulating economic growth and contributing additional public revenues. These measures, and further development of area C, would propel Palestinian economic growth towards achieving economic viability and fiscal sustainability.

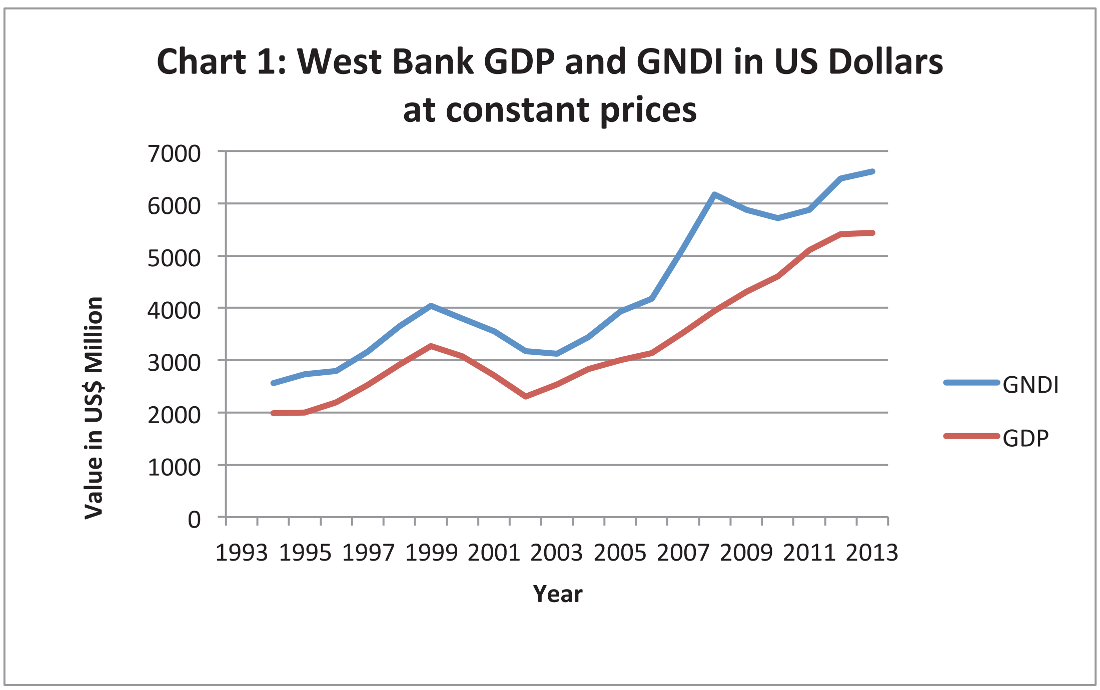
1.

Economic growth, taxation and fiscal deficits

1. Economic growth, taxation and fiscal deficits

In its long history under Israeli occupation, the Palestinian economy was mostly driven by a combination of worker's remittances from employment in Israel (1967-95) and by funding from donor countries and international organizations (2001-2013). This funding, rather than private sector activity, sustained Palestinian public finance. There was only a brief period, (1997-2000) when the economy was sustained from its own endogenous sources of growth and productive capacity: private sector investment, exports, and worker's remittances (chart 1).

Economic viability[1] was attained in the late 1990's when there was still hope of establishing a Palestinian State after the conclusion of the Oslo agreements. Economic growth in 1997- 99 averaged 13.3% in the West Bank[2] and was driven by the private sector (Table 1). Total investment averaged 38% of GDP, a high ratio by international standards. Investment in machinery and equipment, averaged 12% of GDP annually during that period and exports peaked at 20% of GDP in 2000. Fiscal balance was also achieved in the late 1990's since buoyant economic growth lead to high government revenues. To summarize, private sector investment, exports, construction and worker's remittances were all driving the economy.



[1] An economy can be characterized as viable when per capita income does not decline and when it can generate sufficient job opportunities to absorb the increase in the labor force. Indicators of loss of viability would be a sustained increase in unemployment and/or net migration abroad.

[2] For comparison of the 1997-99 to 2007-11, economic growth assessment focuses on the West Bank.

1.1 The tax system under the Paris Protocol

Following the Oslo Accord in 1993 and the Paris Protocol on Economic Relations in 1994 (PP), the Palestinian Authority (PNA) established a modern tax system and expenditure management under the umbrella of the Customs and Monetary Union established with Israel. It adopted Israel's single VAT rate of 17% as well as its custom duties and excises with limited flexibility[3]. International taxes were collected at sources (mostly at Israeli ports) and distributed according to the destination principle—i.e. where final consumption takes place. Taxes on all imports from Israel and other countries were owed to the PNA while indirect taxes on Israeli imports from Palestine were owed to the Israeli Treasury. These tax flows were netted out under monthly "Clearance" sessions. Since the former far exceeded the latter, the PNA became the recipient of "Clearance Revenue" amounting to $ 2 billion in 2014, or two thirds of its total public revenue. Since the tax collection burden for clearance revenue mostly fell on the Israeli tax authorities, albeit at a 3% commission, it allowed Palestinian tax authorities to focus more on its own domestic taxation. In addition to clearance revenue, the PNA was empowered to raise its own taxes in areas under its control (areas A and B amounting to 38% of the West Bank).

Table 1: Major economic Indicators in per cent of GDP, unless otherwise indicated

	1997-99		2007	2008	2009	2010	2011	2012	2013	2014
Real growth West Bank Gaza	12.4 14.3 8.7		6.6 12.7 -2.4	6.1 11.8 -5.1	8.7 9.0 16.0	8.1 7.1 30.1	12.4 10.7 17.7	6.3 6.0 7.0	1.9 0.5 6.0	-2.5 0.2 - 9.8
Cost of living (average)	6.2		1.9	9.9	2.7	3.8	3.2	2.8	1.7	1.7
Exports (goods & services)	18.0		19.3	17.4	15.6	15.3	17.2	16.6	16.5	16.0
Gross Investment o/w plant , equipment	37.6 12.8		18.1 5.4	22.1 5.9	24.6 6.3	22.1 6.0	21.7 6.3	21 6 5.3	22.0 5.4	na na
Construction	10.5		6.1	3.8	6.8	8.7	10.6	9.8	10.8	na
Trade			10.6	9.7	9.8	15.5	17.8	17.8	17.2	na
External transfers to private sector	8.8		23.9	21.6	10.8	10.8	5.4	10.3	9.8	na
Worker's remittances	15.5		10.9	11.2	11.4	12.1	12.0	10.0	10.2	na
ODA	15.2		31.2	37.0	38.7	28.3	21.4	18.0	15.9	15.0
Budget Deficit *	0.0		24.5	20.1	22.3	13.9	12.2	12.9	12.5	12.1
External budget support $	4		1,012	1,763	1,348	1,147	814	925**	1105**	1030

[3] To minimize smuggling and arbitrage, VAT rate in Palestine can only differ from the Israeli rate by two percentage points and gasoline prices cannot differ by more than 15%. In January 2014 VAT in Palestine was set at 16% while in Israel it is 18%.

million % of GDP			18.4	26.4	18.5	10.5	7.8	8.2	8.1	8.2
Unemployment (%)	12		22	27	25	24	21	23	24	27
GDP at current prices US $ million WB GNDI	3942 3348		5506 5797	6673 7644	7268 7254	8913 8367	10,465 9255	11,279 10,423	12,579 10212	12,658 na
WB GNDI/WB GDP	1.26		1.51	1.58	1.4	1.37	1.18	1.23	1.15	na

- In 2013 and 2014 the recurrent budget deficit in this table includes NIS 704 million and NIS 716 million respectively of accumulated electricity charges by IEC which were not included under budget commitments.

An income tax was established, but it only succeeded in obtaining 8 % of PNA revenues, due to a narrow tax base and low compliance (see below). Custom duties on motor vehicles, a domestic value added tax, excise taxes and fees and charges on government services were also imposed. All in all, this "domestic tax" system collected 33% of total net revenue in 2014[4]. While this domestic taxation has a substantial growth potential, it will take several years of taxpayer education, registrations, and enforcement procedures for this potential to be realized.

Overall, this well performing tax system had two major flaws: a disproportionate reliance on indirect taxes which made PNA tax revenue quite regressive; and a large dependence on Israeli good will in transferring clearance revenues and in implementing the Paris Protocol agreement. Over the last twenty years there were five instances when GoI froze clearance revenues for political reasons, the latest episode in December 2014.

With respect to public expenditure, the PNA benefited from technical assistance, which helped with establishing budgetary procedures and expenditure controls. It also benefited from well-trained Palestinian staff, which administered public expenditure under the Israeli Civil Administration prior to 1995. Nevertheless, public finance under the PNA went through a period of learning by doing with rough edges. The General Personnel Council in Gaza was outside the control of the Ministry of Finance in 1995-2003 and capital expenditures were not integrated in the PNA budget but disbursed directly by donors. A milestone was reached in April 2004 when all salaries for security personnel were disbursed to their bank deposits rather than in cash[5].

1.2 Evolution of public finance (1996-2014)

Beginning in 1996, public finance in Palestine took off on a strong footing. Tax revenue rose from 7% of GDP in 1994 to 18.4 % of GDP in 2000, ahead of most countries in the region[6]. This was helped by Palestinian business euphoria in anticipation of the establishment of a State by the end of the Interim

[4] MoF monthly reports: www.pmof.ps
[5] For a description of the early public finance experience by the PNA see Bennett and Nashashibi (2003).
[6] For comparison purposes with other countries revenue and expenditure ratios are taken with respect to GDP. See Bennett and Nashashibi (2003). Table 4.2

Agreement (1999). Yet the PNA wage bill remained stable around 11% of GDP, in line with good public finance management in countries such as Morocco and Tunisia. The recurrent fiscal deficit was only 1.5% of GDP in 1997 but moved to a small surplus in 1998 (0.7% of GDP) and was balanced in 1999[7]. There was no external budget support and foreign aid was limited to financing development expenditures and some humanitarian aid through grants. Both economic viability and fiscal sustainability had been achieved.

By the fall of 2000 all these factors were reversed. The failure to reach a permanent status agreement by 2000, followed by the Intifada, and draconian Israeli restrictions on movement, access, and investment, resulted in a prolonged economic downturn. Between 2000 and 2007, there was virtually no real economic growth[8] and income per capita declined. Large fiscal deficits emerged, particularly in the election years of 2005 and 2006 when there was a burst of wage inflation and a public employment surge, bringing the wage bill to 24% of GDP in 2007.

In 2007 three significant events took place, which charted the growth path for both the West Bank and Gaza. : i) Hamas took over Gaza in June 2007 and established a parallel government, followed by the intensification of the Israeli siege imposed on the Strip since 2006; ii) Following this takeover, a caretaker PNA government headed by Salam Fayyad was established in the West Bank; and iii) the Annapolis Peace Conference took place in November 2007, followed by a donor's pledging conference in Paris in December 2007.

The reestablishment of security in the West Bank, by disbanding the armed militias which had gained control of some cities, and the restoration of law and order with the strengthening of the judiciary, increased business confidence and contributed to some increase in investment, particularly in residential housing. Turning the development strategy upside down, the Fayyad government focused on small community, labour intensive projects, which can be readily executed, as opposed to large infrastructure projects, which would get stuck in the face of Israeli permitting process and import restrictions. This approach revived rural areas, and brought public services and some infrastructure to long neglected villages. Much progress had been achieved by the Fayyad government in building up strong institutions, establishing security, an independent judiciary, and setting up a robust regulatory system.

A top priority of the government, following the establishment of a De Facto Government (DFG) in Gaza, was to undertake a public financial management reform aimed at regaining confidence from the Palestinian public and the international community, after the lapses in fiscal management and financial crises in 2005 and 2006. An emergency budget was adopted in 2007, the budget administration was

[7] These statements have to be regarded with caution as there may have been some extra budgetary expenditures during that period.

[8] GDP at constant prices in 2007 reached $ 4.554 billion while in 1999 it was $ 4.535 billion. (PCBS: National Accounts series with 2004 as the base year).

transferred from Gaza to Ramallah and a PFM infrastructure was being developed. At the same time the government succeeded in shedding over 20,000 people from the MoF payroll who were hired in an employment binge at the end of 2005 and during the 2006 PNA government under Prime Minister Haniyeh from the Hamas parliamentary majority[9].

At the core of the public financial management system a Single Treasury Account (STA), funnelling all government revenues to that account and restoring expenditure controls and cash management with the cooperation of commercial banks. A General Accounting Department was also established at MoF, supported by the launch of a new accounting system. This IT system, managed by BISAN, strengthened payments controls and cash management. An independent external audit agency was established and final 2008 budget accounts were published.

This was supplemented by a new fiscal reporting system to establish transparency and accountability. Beginning March 15, 2008, MoF posted on its web site seven interconnected fiscal tables detailing budget execution and financing during the previous month. Quarterly reports analysed this data and highlighted issues on budget execution. Since then, all sources of public revenue and expenditure as well as sources of financing have been documented, around the 15th of each month. This reporting was subsequently supplemented by public debt tables and development expenditures (limited to funds disbursed through the STA)[10], a level of transparency, which has exceeded fiscal reporting in neighbouring countries, including in Israel.

An independent Palestinian Monetary Authority (PMA) established a strong regulatory system in supervising the twenty banks in Palestine. The PMA has been the only central government authority which maintained its full functions and supervisory role on banking in Gaza, even during the three Israeli assaults[11]. Strict bank supervision by the PMAs fostered confidence in the private sector, which maintained a strong deposit base in these banks (equivalent to 90% of GDP), even under the most acute political and economic crises. Between 2007 and 2014 deposits in the banking system increased from $ 5.1 billion to $ 8.9 billion. Loans increased at a higher rate, from $ 1.7 billion (34% of deposits) in 2007 to $ 4.9 billion (55% of deposits)[12]. Nevertheless, a substantial share of deposits (45%) is left unutilized, given low investment opportunities under the economic restrictions imposed by Israel, and placed abroad, with a contractionary impact on the economy, as discussed below.

[9] PNA employment went down from 166,097 in December 2006 to 145,180 in December 2007. MoF payroll department

[10] Development assistance disbursed directly by some donors was partially registered with the Ministry of Planning but was not incorporated in the Budget

[11] 2008/9; 2012; 2014.

[10]Loans and deposits; www.pma.ps.

1.3 Methodology in assessing public revenue performance

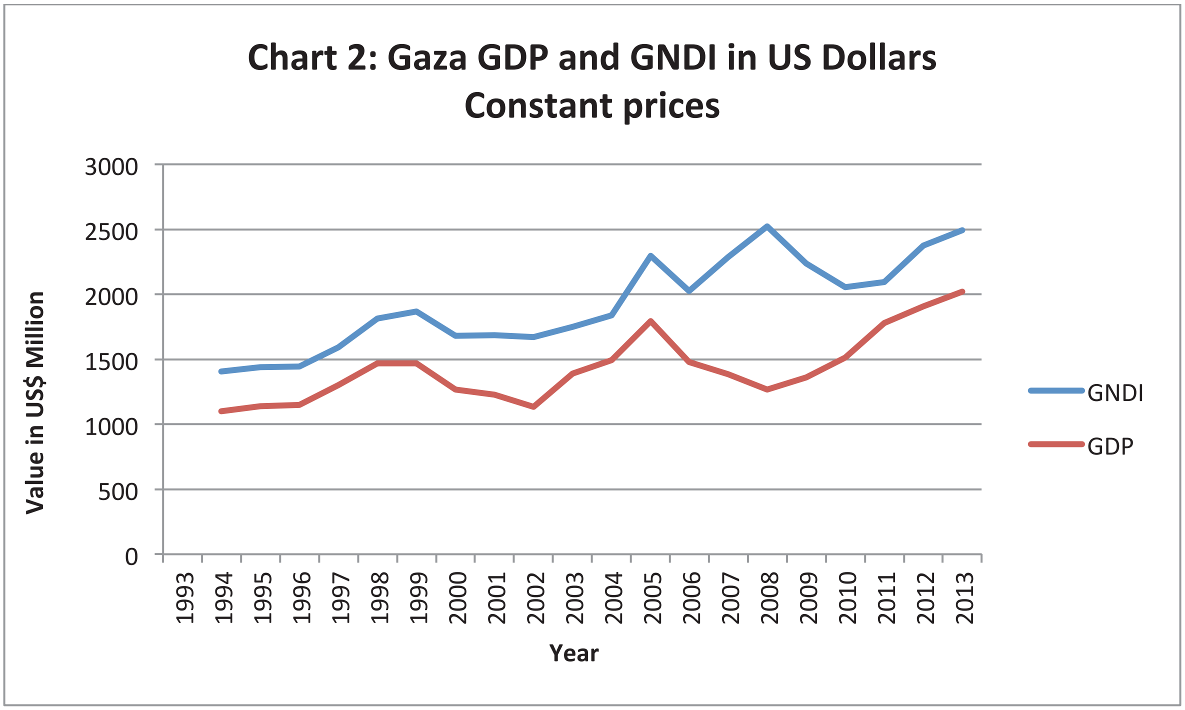
In most countries, economic growth, as measured in GDP increases, is a major driver of tax revenue. However, Palestine has three important characteristics which determine the tax base: a) With 93% of tax revenue emanating from indirect taxes, consumption, both private and public, is the main driver of public revenue[13].b) Consumption in Palestine is much higher than GDP, exceeding it by 20-25% and c) Divergence in growth between the West Bank and Gaza.

The difference between consumption and GDP is financed by three sources of foreign transfers which are not included in GDP: i) Palestinian worker's remittances, mostly from Israel but also from abroad ($ 1 billion in 2013); ii) Official Development Assistance (ODA), including budget support, development financing, and humanitarian aid (ODA, estimated at $ 2. 1 billion in 2013) and iii) net private transfers from abroad including funding of NGO's and transfers to households ($ I.3 billion in 2013). When these three sources of transfers are added to GDP we obtain Gross National Disposable Income (GNDI), which determines the level of consumption. GNDI, rather than GDP, is the best proxy for the tax base in Palestine. Moreover, GDP and GNDI in the West Bank are better indicators of economic growth under the web of Israeli restrictions on economic activity, but without external shocks, such as warfare or siege in Gaza. GDP growth in Gaza has been volatile due to three Israeli incursions (2008/09; 2012; and 2014) and import instability due to the Israeli siege since 2006 (Charts 1 and 2).

To summarize, there are two drivers of overall consumption, which fuel tax receipts: the growth in economic activity (GDP accounting for about 75% of GNDI) and the growth of worker's remittances and official and private transfers from abroad.

The third characteristic pertains to the divergent trajectories of real GDP and GNDI between the West Bank and Gaza (table 1). Growth in the West Bank has been relatively high at an annual average of 9.8% during five years (2007-11), as a result of large external assistance peaking at $ 2.8 billion in 2008[14], and the financing of wage arrears incurred in 2006 and 2007. With the withdrawal of fiscal stimulus following the reduction of the budget deficits from 20% of GDP in 2008-09 about 13% in 2011-14, economic growth in the West Bank declined by half in 2012 (6%) and again to virtual stagnation in 2013 (0.5% Chart 3).

[13] In Jordan, Lebanon, Morocco, and Tunisia the share of indirect taxes in total revenue is about 50% in 2011. In Israel it is 34%. IMF. Government Finance Statistics.
[14] Based on OECD DAC data, MoF data, UNOCHA-FTS data and CAP reports.



Source: PCBS National Accounts; the budget deficit in 2009 excludes $ 300 million for Gaza emergency expenditures * estimates from latest PCBS data at current prices. ** includes $ 150 million expected from the US in 2012 but disbursed in 2013; na: not available;www.pcbs.gov.ps;www.pmof.ps.

By contrast, growth in Gaza has been subject to punitive Israeli actions such as the protracted siege imposed since 2006; Israeli incursions in 2008-09, the intense aerial strikes in November 2012 and the July-August 2014 devastating war. Gaza's growth was negative in 2007-8 but picked up in 2009-11 as a result of the tunnel trade. It declined in 2012-13 with the destruction of the tunnels and became negative in 2014. The incursions and repeated attacks destroyed Gaza's economy and reduced it to a welfare state. While GDP went down, GNDI went up, due to higher welfare transfers from the donor community (Chart 2).

Moreover, there has been a structural shift in the revenue shares contributed by the two regions. After the takeover of Gaza by Hamas in June 2007, President Abbas exempted Gaza residents and companies from the income tax. In addition, the tightening of the Israeli siege on Gaza since 2007, which limited imports from Israel to 26 items, also reduced the flow of indirect taxes from Gaza to the PNA from 28% in 2005 (before the Israeli disengagement from Gaza) to about 8% by 2013[15]. The tunnel trade with Egypt, which prospered under ex-Presidents Morsi and Mubarak, gave Gaza an alternative outlet for imports, particularly construction material but was subsequently suppressed by Minister of Defense and now president Sissi in 2013-14. In effect, it is the West Bank tax base and its proxy West Bank GNDI, which bore the brunt of mobilizing tax revenue for the PNA until 2014, when there was some recovery in Gaza's taxation.

[15] MoF, monthly clearance revenue data

2.

Losing fiscal sustainability

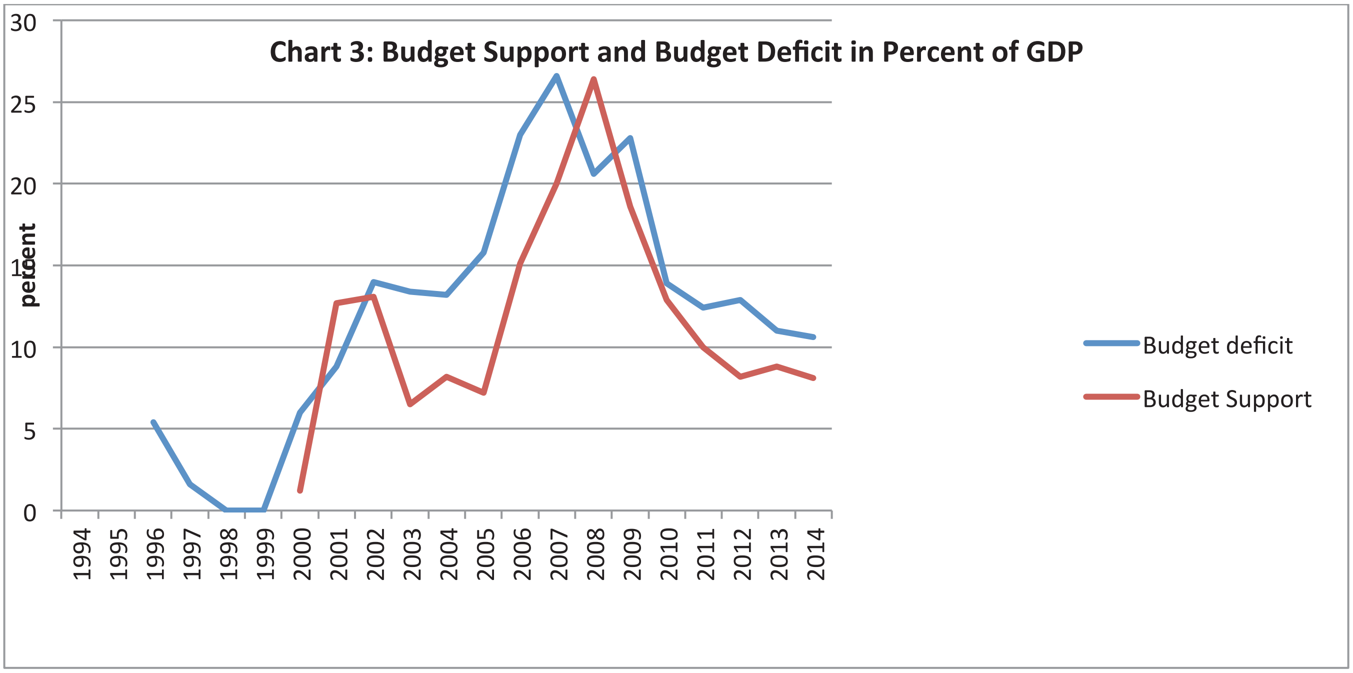
2. Losing fiscal sustainability.

Fiscal sustainability would be attained when a moderate budget deficit can be financed in an orderly and transparent manner, without raising inflationary pressures or raising the public debt beyond prudential norms. During the 2010-14 periods, the sizeable, double digit budget deficits, coupled with the decline in external budget support, the accumulation of unfinanced budget gaps and large payment arrears to the private sector, were strong indicators that PNA fiscal sustainability has been lost (chart 3).

After a major deficit reduction in 2008 and 2009, in the aftermath of repayments of wage arrears incurred in 2006-07, and the shedding of a large number of employees hired following the election of Hamas in 2006, attempts at further reductions of the recurrent budget deficit encountered both political resistance and strong bureaucratic inertia. Nevertheless, the PNA recurrent budget deficit has been reduced, from 14% of GDP in 2010 to 12% of GDP in 2014, a modest achievement. Moreover, it is still substantially higher than the deficit ratio to GDP in Palestine's neighbouring countries in the region [16](table 2).

Financing gaps emerged every year resulting in a monthly struggle to meet PNA salary payments. Periodic delays in salary payments as in July and August 2012 undermined confidence in the PNA public finance management. Substantial progress was achieved, on the wage bill front (see below), but given the magnitude of the deficit, the reduction in the actual budget deficit during 2010-14 was not sufficient in eliminating the financing gaps in the face of a sharper reduction in external budget support. Since 2009, with the election of a new Israeli coalition government, negotiations with Israel on establishing a Palestinian State stalled and, budget support, which is mostly sustained by expectations of success, declined. Indeed it did, from 26% of GDP in 2008 to 8% of GDP in 2014 (table 1). Chart 3 clearly shows how external budget support declined after 2012, while budget deficits declined from 20% of GDP in 2008 to 12% in 2014.The financing difficulties which the PNA has been experiencing coupled with the accumulation of private sector payment arrears, with its corrosive effects on private sector activity, would have warranted a more substantial effort at deficit reduction.

[16] Egypt 3.2%;; Jordan 4.9%; Lebanon 7.5%; Malta 6.3%; Tunisia 0.5%; Turkey 4.7%. All data are for 2010, prior to the effects of the Arab Spring. IMF: Government Finance Statistics.



The Palestinian fiscal deficit is not cyclical, nor is it due to expansionary fiscal policy, or low tax collection capability. Rather it is a structural deficit, largely due to the economic restrictions imposed by Israel, which have repressed economic growth and public revenue, and only partly due to policy choices enacted by the PNA and donor forbearance. Low growth in PNA revenue, a narrow domestic revenue base, a large wage bill and high population growth are the major parameters of Palestinian public finance. These rigidities have become imbedded in Palestinian public finance and, unlike discretionary policies, such as changes in tax rates, which can be reversed; they tend to be resistant to reform.

Typically, public revenue trends are largely determined by economic growth and external transfers while public expenditures tend to grow in line with population growth and inflation. At a minimum, services provided by the government need to be maintained in real terms on a per capita basis. An analysis of fiscal sustainability of the PNA must consider five factors: 1) the level of Israeli economic restrictions 2) progress (or lack thereof) in the peace process, which largely determine investor's expectations, investment, and economic growth; 3) Public revenues trends, including improvements in tax administration and tax policy; 4) Trends in public expenditures, including retrenchment policies and 5) Availability of budget deficit financing from both domestic and external resources on a sustainable basis.

2.1 Impediments to economic growth under Israeli restrictions

Growth in private sector activities has been repressed by a comprehensive web of Israeli economic restrictions since 2000. Restrictions have been imposed on the movement of trade and people in the

West Bank through the erection of over 500 barriers and checkpoints, permit requirements for imports of capital equipment, and by the imposition of a siege on Gaza since 2006, with strong trade impediment persisting since the outbreak of the second Intifada. This has raised Palestinian transaction costs substantially and lowered labour productivity undermining the competitiveness of its traded goods.

The inability to develop “area C” which covers 62% of the West Bank, particularly the Jordan Valley, has deprived the private sector from its major sources of growth, taking away about 23% of potential Palestinian GDP[17]. This potential output would have added $ 800 million in tax revenue, reducing the need for external budget support by more than half. In addition, the private sector is unable to exploit its natural resources, such as natural gas, crude oil deposits in the northern West Bank (Rantis) and water resources, which are controlled by Israel well below an equitable distribution[18]. Palestine was also denied constructing an airport in the Jordan Valley and a port in Gaza, turning it into a landlocked country. All access in and out of the West Bank and Gaza has been controlled by Israel[19].

Restrictions on imports, particularly technologically advanced capital goods, through the “dual use” list, limited the ability of the private sector to renew its machinery, adopt new technologies or upgrade its equipment. While “Despite a marked increase in the effectiveness of PA security efforts and improvements in the overall security situation in the West Bank, Israel has not relaxed its dual-use control regime. On the contrary, more goods were added to the list during this period of relative stability and the control regime has become more restrictive”[20]. National accounts reveal that gross capital formation in plant and equipment has declined dramatically since 1997-99, from 12% of GDP to 5% of GDP in 2013, despite the improvement of the overall economic environment under the Fayyad government[21]. This investment rate in machinery and equipment was barely sufficient to provide for normal depreciation, implying that net investment may be zero or negative. In 2012 the World Bank stated “capital accumulation does not appear to have played an important role in the recent growth”[22].

[17] World Bank: Area C and the Future of the Palestinian Economy. October 2, 2013
[18] World Bank: Assessment of Restrictions on Palestinian Water Sector Development, April 2009.
[19] Except for the Egyptian border at Rafah. However, since July 2013 movement of people has extremely limited; reduced to humanitarian cases.
[20] USAID: The impact of Israeli restrictions on the transfer of dual-use goods to the West Bank. January 2010 p4
[21] National accounts do not distinguish between private sector and public sector investment. Rather, the distinction is between “buildings” and “non-buildings”. The former includes government expansion into new buildings as well as residential construction while the latter is plant and equipment, mostly invested by the private sector.
[22] World Bank: Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector Led Growth in a Future Palestinian State. April 2012

A recent growth accounting analysis by the Aix Group showed that while education in Palestine has risen substantially over the last decade, it was not translated into increases of labour productivity due to lack of physical capital and constraints on labour and management mobility[23].

Restrictions on labour and management travel between the West Bank and Gaza and abroad for training and restrictions on experts traveling to the West Bank and Gaza have limited the upgrading of skills, transfer of technology and integration in the global economy.

The export share in GDP declined from 19% in 2007 to 16% of GDP in 2013, partly because Israel prohibited Gaza exports from going into the Israeli and West Bank markets (table 1). For a small economy with location advantages and a wealth of cultural and religious sites, it should have been much higher, as in Jordan (44%) or Israel (27%). However, difficulties in accessing foreign markets, high transaction costs that undermined competitiveness limited the diversification and expansion of exports[24].

The IMF estimates an output gap by 2010 at 88% if output growth in the Palestinian territory during 1968-87 had maintained its trend[25]. If economic growth had taken its normal course, PNA revenues in 2010 would have reached $ 3.8 billion, resulting in a substantial recurrent budget surplus[26]. Looking at it from another angle, the annual fiscal costs of the occupation were estimated at $ 2 billion, exceeding the current deficit levels.[27]

An evaluation of the cost of occupation --restrictions on water use, natural resources, export and import restrictions, fiscal revenue foregone -- were estimated at $ 7 billion[28] or 85% of 2010 GDP. They also indicate that growth and PNA revenue would have been substantially higher under a sovereign state, bringing with it balanced recurrent budgets or surpluses. The occupation regime and its economic restrictions defined the evolution of Palestinian public finance and are the root cause of its fiscal deficits.

Yet, despite these restrictions and the decline in private sector investment, Palestinian economic growth in real terms increased steadily from 6.6% in 2007 to 12.4% in 2011, but then declined precipitously to 6.3% in 2012 and 1.9% in 2013 or into negative per capita income growth territory.

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[23] Joseph Zeira and Tal Wolfson: Palestinian Economic Development: Barriers and Obstacles and the Cost of Occupation. The Aix Group, January 2015

[24] See Gal, Nashashibi, and Rock; PIBF Research Paper 2015, pp26-28

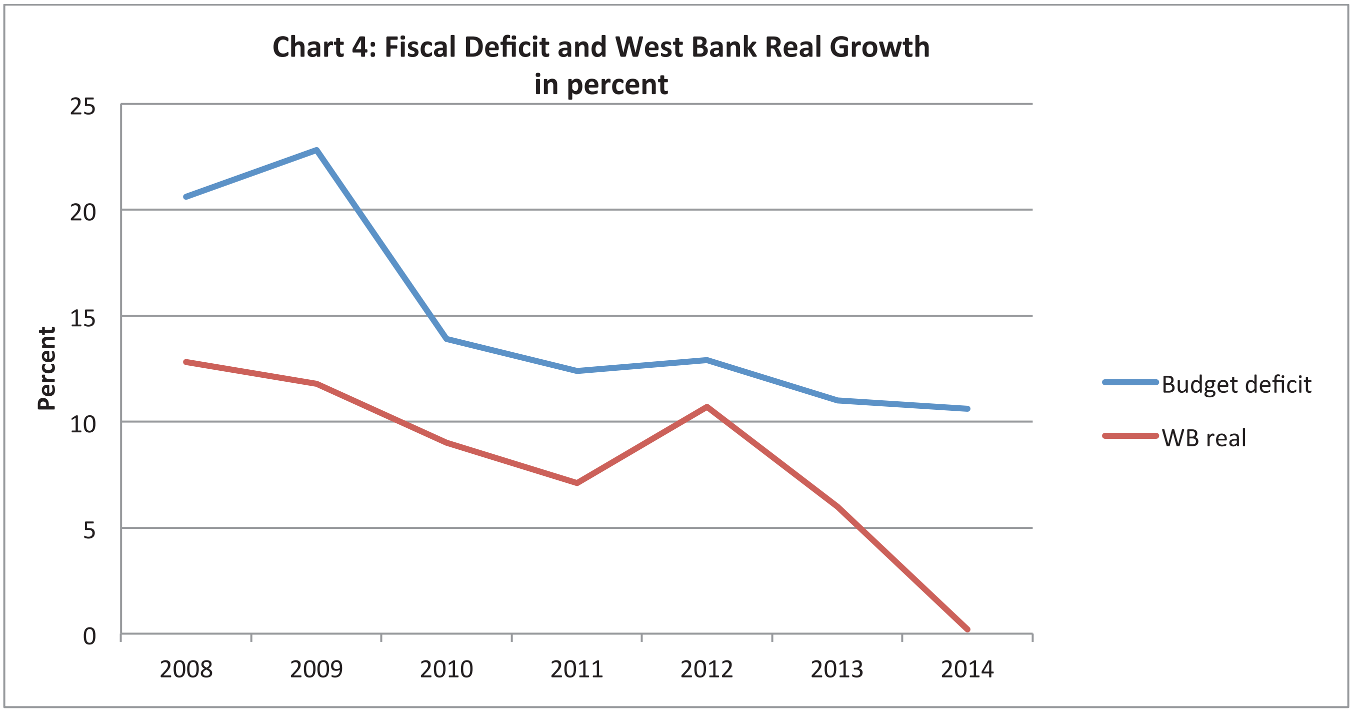
[25] Alternatively, if median trend output growth of comparator countries is taken, the output gap would have been 78%. See IMF Staff report for the Meeting of the AD Hoc Liaison Committee, Brussels, April 13, 2011 Box 2, p. 8

[26] Assuming annual trend output growth of 4.4%, as was the case during 1968-87. See IMF AHLC report, April 13, 2011.

[27] The economic costs of the occupation, op cit, p 5

[28] Direct and indirect costs; see Ministry of National Economy and ARIJ: “The bulletin on the economic costs of the occupation for Palestine” September 2011, p4

Projections for 2014 point to a decline in real GDP by -2.5%[29]. Therefore, if one cannot attribute to the private sector any significant contribution to growth through exports and investment during 2007-14, what has caused growth to reach double digit levels in 2008 and 2009 and subsequently to decline to stagnation levels ? A look at Table 1 and Chart 4 provides the answer.



2.2 Fiscal deficits and economic growth

The Annapolis Conference in November 2007 and the formation of a credible and decisive Palestinian government ushered a new wave of optimism and an exceptional level of support from donor countries. At the Paris pledging conference $ 1.6 billion were committed and actual disbursements in 2008 for budget support reached $ 1.76 billion[30], a level of support unprecedented for such conferences. ODA increased from $ 1.7 billion in 2007 to a peak of $ 2.8 billion in 2009 and GNDI increased in 2008 by 40% over 2007, exceeding GDP by 58%[31].

However, the accession of a coalition government in Israel, which seemed conflicted about a two state solution to the conflict, and the receding political horizon towards the establishment of a sovereign Palestinian State, resulted in “aid fatigue” causing a steady decline in ODA to $ 2.0 billion in 2012, and about the same level in 2013. Data on external budget support for 2014, point to a further decline to

[29] PCBS : Press Release, December 30, 2014
[30] Pierre Duquesne: L’état sans l’état ; Diplomatie et économie, 2013
[31] OECD DAC data; MoF monthly fiscal reports; PCBS National accounts

about $ 1 billion in external budget support, while the 2014 Budget projected this support to reach $ 1.35 billion. IMF projections for 2015 point towards budget support around $ 850 million[32].

In the face of weak private sector investment since 2009, and declining external transfers, a major engine of growth in the Palestinian economy has been the fiscal stimulus resulting from large recurrent budgetary deficits, mostly financed by budget support from the donor community. The large ODA flows mentioned above enabled the PNA to sustain fiscal deficits of 24% of GDP in 2007 and 22% of GDP in 2008[33], but as foreign assistance declined, budget deficits had to decline as well, for lack of alternative financing (Chart 4). The decline in external assistance and budget deficits was not offset by other external flows. On the contrary, private transfers from abroad fuelling purchasing power into the economy, declined as well from 24% of GDP in 2007 to about 10% of GDP in 2012-13 (table 1). Workers' remittances also declined from about 11% in 2007-08 to 10% in 2012-13[34]. Nor could the PNA rely on additional bank borrowing which has been close to reaching the notional limit of total bank equity ($ 1.36 billion).

This, in turn, sharply reduced real economic growth from 12% in the West Bank in 2008 to an estimated 0.2 % in 2014 (Table 1 and chart 4)[35]. In Gaza, there was a decline in growth in 2014 by 10%, mostly as a result of the July/August war. In fact, there were two forces pulling the Palestinian economy down to a low growth spiral: the withdrawal of fiscal stimulus, without any other economic aggregate picking up the slack, and an outflow of Palestinian savings abroad due to the lack of investment opportunities at home under the Israeli control regime. Surprisingly, neither of these factors was highlighted by the IFI's in more than a dozen AHLC reports presented since 2007.

2.4 Contractionary impact of the bank credit/deposit balance

A second contractionary impact emanated from the inability of the banking system to fully utilize the annual increase in residents' deposits and the placement of unutilized deposits abroad. To put it simply, credit expansion has not kept up with the increase in bank deposits (Table 2). In 2012 this contractionary impact amounted to $ 506 million or 5% of GDP. While it has been reduced in 2013, it is rising again in 2014. Since 2007, almost $ 3 billion of Palestinian deposits have been transferred abroad, for lack of credit demand at home. There was a build up of foreign assets abroad exceeding $ 1 billion yearly since 2011 and reaching 32% of total assets in 2013, far more than other countries in

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[32] IMF mission to the West Bank and Gaza: Main findings of the IMF Mission, January 29, 2015. The MoF Emergency Budget for 2015 projects external budget support at $ 800 million.

33 By comparison, the fiscal stimulus provided by the US Treasury at the height of the 2009 fiscal crisis ($ 760 billion) amounted to 6% of US GDP.

[35]. Projection for 2014 is from PCBS press release on December 30 2014. These projections are consistent with those of the IMF, AHLC report September 22nd 2014.

the region, (Egypt; Jordan Lebanon; Morocco) with foreign assets at less than 10% of total assets[36]. It is certainly better to accumulate foreign assets abroad than engage in risky investments at home but it is somewhat disconcerting that during a period when there was hardly any net investment in Palestinian productive capacity and infrastructure, $ 3 billion of Palestinian savings have been invested abroad, drawing purchasing power away from the Palestinian economy.

Table 2: Increase in deposits and credit facilities in the Palestinian banking system (US $ millions)

	2007	2008	2009	2010	2011	2012	2013	2014	2007-14
Increase in deposits	916	729	415	649	146	465	780	649	4749
Increase in credit	-147	-38	504	652	-249	-41	712	416	1773
Contractionary impact	1063	767	-89	-3	395	506	68	233	2976

PMA: Distribution of deposits and credit facilities in Palestine by type. www.pma.ps

2.5 Fiscal outlook for 2015-17

While the recurrent budget deficit seems to be stuck at 12% of GDP, the withdrawal of fiscal stimulus is bound to continue, if only to make ends meet, in the face of further reductions in external budget support to the PNA. This, coupled with the current political uncertainties, particularly in the aftermath of the Gaza war and the Israeli March 2015 election results, will continue to bring down expectations, economic growth, and with it, PNA revenues. IMF projections for West Bank economic growth in 2015 point towards a decline of 2-3% mostly as a result of only 77% of salaries being paid following the freeze in clearance revenue transfer[37]. Gaza, on the other hand may bounce back from the 2014 decline towards a 10% increase. Since it is the West Bank, which generates 82% of PNA revenue, a sharp decline in growth prospects and decline in per capita income will also entail a decline in public revenues.

Fiscal projections over 2015-17, under status quo political and economic conditions, indicate a swelling of fiscal deficits, due to weak revenue performance and yearly increases in expenditures in the 3-5% range, if only to maintain the level of public services on a per capita basis. With budget support expected to decline to about $850 million in 2015 and remain around that level in 2016-17, large

[36] PCBS, Preliminary results of the Balance of Payments 2011-2014; PMA Monetary survey. The high percentage of Palestinian assets held abroad exposes the banking system in Palestine to external and regional risks.

[37] IMF: West Bank and Gaza: Main Findings of the IMF mission; January 29, 2015. Salaries at NIS 2000 and below are being paid in full while salaries above that level are being paid at 60%.

financing gaps are likely to emerge[38]. The MoF emergency budget for 2015 projects a financing gap of $350- 400 million. The PNA would be financially unsustainable.

A reintegration of Gaza with the West Bank under the umbrella of the GNC, along with redeployment of customs officials to border crossings in Gaza and collection of greater clearance revenue may result in a dramatic upsurge in Gaza's growth. In 2011, with trade restrictions eased by the tunnel trade and Israel's relaxation of the siege, Gaza's real growth soared to 18%. With greater security under the purview of the GNC, Israel may relax movement and access through its border and allow Gaza exports to the Israeli market and the West Bank. While this may not fully restore fiscal sustainability for Palestine, it would be a major step in that direction. However, by mid-March 2015, no progress whatsoever, has been achieved in this direction.

[38]IMF: West Bank and Gaza report to the AHLC September 22, 2014, table 1. Estimates of annual financing gaps for 2015-17 range between $ 660 million and $ 565 million depending on projections of external budget support, policy changes underpinning the growth in revenues, and growth in expenditures. For instance, IMF projections of annual expenditure increases of 2.5%, far lower than during previous years, imply major policy actions to control expenditure growth.

3.

Public finance performance

3. Public finance performance

3.1 Public revenue trends

Public revenue performance has been mixed over the past five years, depending on the comparison criteria. When measured against total GDP between 2007 and 2013, net revenue declined by 3.4 percentage points (chart 5), but recovered in 2014 to the same level as in 2007, with Gaza contributing much higher clearance revenue[39]. Since Gaza virtually dropped out of the tax base until 2013, West Bank, GNDI would be more appropriate as the tax base during that period. Total net revenue declined from 23.2 % of WB GNDI in 2007 to 22.3% in 2013, a modest decline consistent with the expectation that public revenue ratios tend to be stable with respect to their tax base, unless policy changes occur. However, the decline against West Bank GDP is much sharper: from 29.9% in 2007 to 24.0% in 2013. These trends indicates that taxable sectors in the economy narrowed markedly, as more and more activities entering GDP have been paying fewer or no taxes. The fastest growing sectors in the economy—construction, services, and retail trade are also the ones with a large informal sector and lowest tax registration and compliance. The GDP share of construction rose from 6.1% of GDP in 2007 to 10.8% in 2013 (Table 1). Similarly, retail and wholesale trade increased its share from 10.6% of GDP in 2007 to 17.2% in 2013. These increases were at the expense of more formal activities such as manufacturing, telecommunications and financial services where tax compliance is much higher.

Table 3: PNA revenue and expenditure (NIS millions, unless otherwise specified)

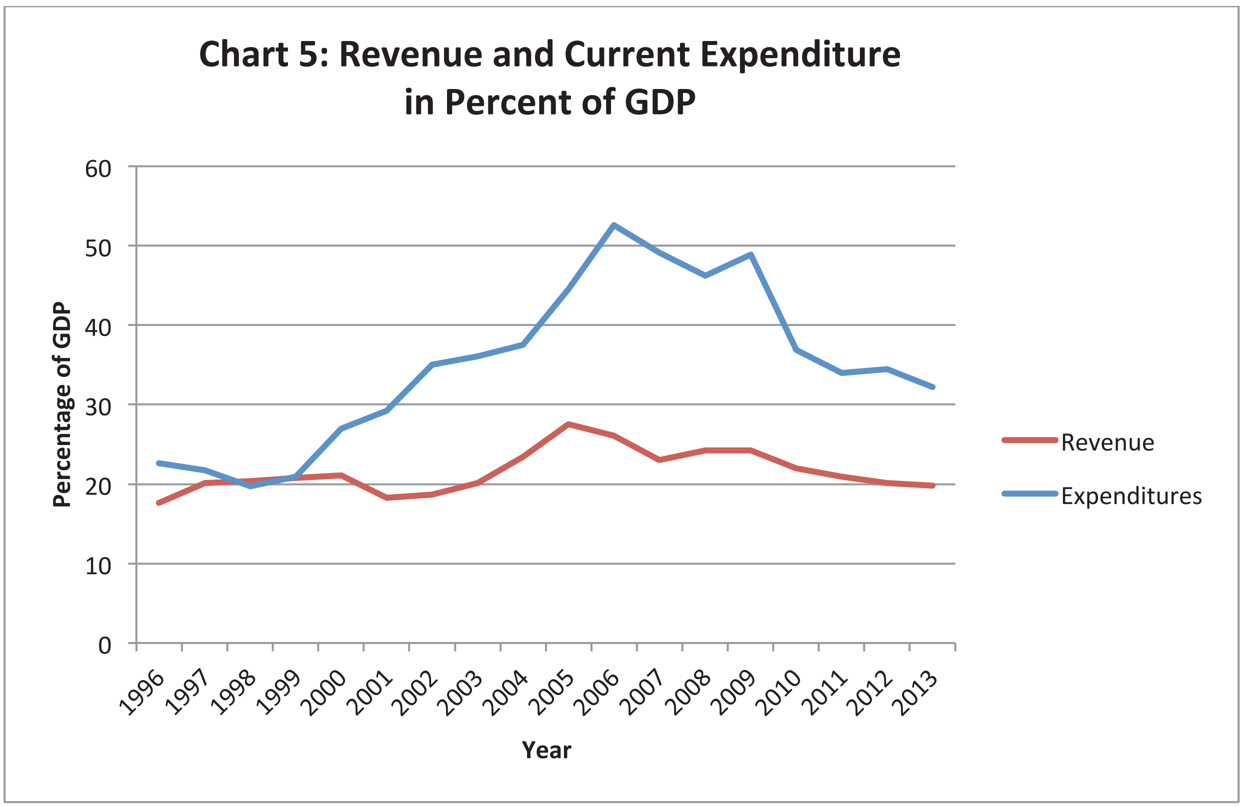
	97-99	2007	2008	2009	2010	2011	2012	2013	2014
Net Revenue	3494	4899	5,356[40]	6,332	6,847	7,321	7,989	8,347[41]	9,817
% WB GNDI	*27.0*	*20.12*	*18.0*	*22.4*	*21.9*	*22.1*	*19.9*	*20.1*	*n.a.*
% GDP	*22.8*	*21.7*	*22.7*	*22.3*	*20.6*	*19.5*	*18.4*	*18.3*	*21.7*
Tax revenue	3078	4,399	4,527	5,244	5,838	6,406	6,975	7,286	8,956
% WB GNDI	*25.8*	*18.5*	*15.1*	*18.5*	*18.7*	*19.3*	*17.3*	*18.0*	*n.a.*
% of WB GDP	*27.3*	*26.9*	*24,7*	*24.3*	*23.6*	*22.6*	*21.1*	*21.0*	*n.a.*
-Net Clearance[42]	2,036	3,571	3,561	4,058	4,412	4,679	5,183	5,312	6,807
Non-tax	416	827	829	1,088	1,009	915	954	921	966
WB GNDI	12905	23768	29812	28292	31209	33133	40155	40349	n.a.
Expenditure	3361	10,426	10,215	12,808	11,476	11,897	13,593	14,040	15,272
% GDP	21.9	*46.2*	*43.2*	*45.2*	*34.5*	*31.7*	*31.3*	*30.8*	*33.8*
Wage bill	1848	5,260	5,145	5,813	6,019	6,381	6,812	6,928	7,336
% of GDP	12.0	*23.3*	*21.8*	*20.5*	*18.1*	*17.0*	*15.6*	*15.2*	*16.3*
Non-wage	1499	2,973	3,488	5,577	4,577	5,015	5,709	5,648	6,197

[39] The decline in GDP also pushes GDP ratios upward.
[40] Excludes an accounting procedure of NIS 893 million provided by the PIF to MoF in 2008 in exchange of repaying a debt to the PIF of NIS 893 million on the same day.
[41] General Budget Law, 2014. The monthly fiscal reports provided a figure of NIS 8495 million.
[42] Gross clearance minus refund of fuel excise

Net lending*	0	2,194	1,582	1,418	880	501	1,072	1,464	1,738
% GDP	0	*9.7*	6.7	*5.0*	*26*	*1.3*	*2.5*	*3.2*	*3.8*
Current Deficit*	-133	5,527	4,859	6,476	4,630	4,576	5,604	5,693	5,455
% of GDP	*0.0*	*24.5*	*20.1*	*22.3*	*13.9*	*12.2*	*12.9*	*12.5*	*12.1*
Development	931	1,271	1,050	1,018	1,114	1,324	937	674	937
% of GDP	*6.1*	*5.6*	*4.4*	*3.6*	*3.6*	*3.5*	*2.2*	*1.6*	*2.1*
Budget deficit*	965	6,798	5,016	7,481	5,744	5,900	6,541	6,367	6,392
% of GDP	*5.1*	*30.1*	*21.2*	*26.4*	*17.3*	*15.8*	*15.1*	*14.0*	*14.1*
GDP nominal NIS million	15,325	22,574	23,624	28,345	33,245	37,466	43,424	45,536	45,188
NIS/US $	3.8	4.1	3.54	3.9	3.73	3.58	3.85	3.62	3.57

- For 2013 and 2014 these numbers include NIS 704 million and NIS 716 million respectively of accumulated electricity charges due to IEC but not included in budget commitments.

Source: MoF data from monthly fiscal reports; PCBS new national account series released in September 2014.



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In 2014, MoF launched a revenue mobilization strategy to improve tax administration and broaden the taxable base. These efforts have focused on three areas: Income tax, domestic VAT administration and trade and financial relations with Israel. A major registration drive is being undertaken to broaden the income and domestic VAT tax bases. The investment promotion law coverage is being narrowed down

through legislative amendments. In addition, since Gaza has been compelled to import fuel through Israel, after the closure of the tunnels to Egypt, clearance revenue are expected to increase substantially. In 2014 there was a 28% increase in clearance revenue as opposed to the 7.2% increase projected in the 2014 budget. The difference realized between the budget projections and actual clearance revenue (NIS 786 million) can be mostly attributed to Gaza fuel imports[43]. This was the first step in restoring Gaza's share of PNA clearance revenue which is expected to increase from 8% in 2013 to 18% by end 2014. However, this process may be partly offset in 2015 by expectations of stagnation in Palestine as a result of much slower reconstruction in Gaza than expected and the withholding by Israel of clearance revenue for three consecutive months beginning in December 2014.

3.2 Expenditures trends

While tax revenues in Palestine suffered a major setback under the economic restrictions imposed by Israel since 2000, expenditures continued to increase. With rapid population growth and yearly increases in education and health services, if only to maintain their levels on a per capita basis, one would expect an annual increase in recurrent expenditures of about 3-4 % in real terms. In addition, a major effort was launched to establish security and justice in the West Bank and more recently, a build up of a complex of buildings for ministries offices[44]. However, there were also some lapses to sound public expenditure policy: two large wage increases --in 2003 and in 2005—and a major burst in PNA employment in 2006-07 raised the wage bill from 12% of GDP in 1997-99 to 23% of GDP in 2007 (Chart 5). As mentioned earlier, with the onset of the Fayyad government in 2007, a major retrenchment in the wage bill took place, with a gradual decline to 16.3 % of GDP by 2014. Nevertheless, other expenditure items emerged, offsetting some of the progress made on the wage bill, such as the pension payments, transfers to prisoners and vulnerable families, and development expenditure financed from recurrent revenues. Thus, non-wage expenditures, including transfers and the electricity subsidy, also more than doubled from 10% of GDP in 1997-99 to 23% by 2007. These were then reduced gradually to 16% of GDP by 2014.

Overly generous retirement policy for PNA employees, particularly security services have become a major burden on the recurrent budget. Since the PNA has been unable to transfer employee and government contributions to the Pension Fund on a regular basis, pensions are now being disbursed from the recurrent budget on a "pay as you go" basis. On the positive side the PNA has been less burdened by the plethora of subsidies and costs which have been the bane of many of the countries in the region: the PNA does not have food subsidies, petroleum subsidies[45], housing subsidies, or interest

[43] There may have been some improvements in the collection of VAT invoices but they haven't been quantified.
[44] Up until 2012 the PNA mostly relied on renting office premises.
[45] Diesel fuel pricing in Palestine is above international prices and does not qualify as a subsidy. The loss in revenue results from lowering the excise tax to the consumer, relative to Israeli pricing.

subsidies. Nor does it have large loss-making public enterprises. So far, it has only had an implicit but large electricity subsidy, which has been reduced from 7% of GDP in 2007 to 2.3% of GDP by 2014.

Looking at PNA public expenditure history, total recurrent expenditure increased faster than gross revenues, from about 22% of GDP in 1997-99 (NIS 3,361 million) to 34% of GDP by 2014 (chart 5). By contrast, total net revenue, which reached 23 % of GDP in 1997-99, declined to 22% by 2014.

Overall, despite a major retrenchment in recurrent expenditures since 2007, expenditures increased by twelve percentage points of GDP since 1997-99, whereas revenues declined by about one percentage points of GDP, resulting in a deterioration of the fiscal balance by about 13 percentage points of GDP during the 1999-2014 period. Since 1997-99, recurrent expenditures more than quadrupled to NIS 15.3 billion, while revenue only increased by 2.6 times to NIS 9.8 billion. While the divergence between the trajectories of revenue and recurrent expenditure has narrowed, current fiscal policies are not expected to reduce the difference further in an environment of declining economic growth. The gap between revenues and expenditure trends and the inability to bridge this gap under the current fiscal policy framework, remains at the core of the loss of PNA fiscal sustainability.

3.3 Development plans and development financing

Until recently, there were no reliable estimates on development expenditures, partly because most of them were disbursed directly by donors to subcontractors, outside the PNA budget. Nor has there been a clear distinction between donor commitments and actual disbursements, or a consistent breakdown between capital formation, technical assistance and transfers to humanitarian agencies and NGO's[46]. Development expenditures averaged 5.7% of GDP in 1997-99 and after a sharp decline during 2000-04 they rose back to that level by 2008[47]. Infrastructure expenditures financed by donors, faced a major implementation problem with imported capital equipment lingering for 2-3 years at Israeli ports under security and permitting procedures[48]. With the failure of the Annapolis peace process and the restrictive Israeli measures hampering implementation of investment projects in "Area C", budgeted development-spending fell back to 2% of GDP in 2014. This is well below normal maintenance and depreciation rates, implying negative net capital formation in the public sector.

[46] Over the last three years MoPAD has been monitoring development spending by donors through its DARP accounting system. Nevertheless, a number of donors are still not providing data on actual disbursements.
[47] PRDP accounting of disbursements in 2008, which marked the peak of development expenditures, was $ 181 million for infrastructure; $ 178 million for security and the rule of law; and $ 242 million for health, education and social sectors. See PNA: Interim Briefing on International Assistance to the Occupied Palestinian Territory, 2008.
[48] Equipment to build a port in Gaza; equipment for cellular phone companies and utility projects.

Table 4. Development expenditure and financing in NIS million

	2007	2008	2009	2010	2011	2012	2013	2014
Development expenditures	485	1,050	1,018	1,114	1,324	937	674	937
Development financing	410	771	900	487	605	601	384	762
Financing gap	75	271	118	627	719	336	290	175

Source: MoF monthly reports and MoF budgets

Actual development spending, as shown in tables 4 and 5, only includes spending which is either financed from the Treasury or channelled by donors through the Single Treasury Account. It does not include projects financed directly by foreign donors. A UNDP position paper shows "Programmable Development Assistance" (for government, NGOs and INGOs) increasing from $ 560 million in 2009 to $ 847 million in 2011 and declining to $ 704 million in 2012[49]. While the trends in the two series are consistent, these numbers are much higher, partly because they include direct disbursements by donors and NGOs.

MoPAD's vast data base (DARP) has gathered information on projects funded directly by donors, but the information provided by donors is not sufficiently detailed, timely and updated. Moreover, while DARP follows international OECD and Plan classification for ODA flows, MoF uses the integrated Financial Information Management System (FIMS) budget classification, which is incompatible with the former[50]. Therefore, it has been very difficult to construct a series on public investment, which would tie in with the annual budgets, and gross capital formation series in the National Accounts[51]. Nor is there a systematic evaluation of each project, its status, and linkages to Plan objectives and financing. This would have established evidence-based decision making for Plan formulation and linkages with the annual budget.

Over the past three years budgeted development expenditures declined sharply from NIS 1.3 billion in 2011 to NIS 937 million in 2014. Moreover, most of this spending has been focused on capacity building, enhancing security and public buildings. Has the donor community given up on capital formation in Palestine? Of the NIS 674 million spent on development in 2013 through the STA only NIS 25 million were spent on infrastructure towards building four electrical substations in the West Bank in cooperation with GoI and EIB. Of the much publicized $ 4 billion Kerry Plan unveiled in April 2013 (which morphed into the Initiative for the Palestinian Economy (IPE)), not a single project has been

[49] Gerhard Pulfer: "Limitations in Translating Palestinian National Development Plans into Results on the Ground" a UNDP position paper; March 2013

[50] Op.cit. page15

[51] National accounts breaks down investment between Building and Non-building (machinery and equipment) but is not able to distinguish between public and private investment.

implemented. While the Plan was predicated on private sector investment, stimulated by progress in negotiations with Israel, public utility projects (electricity substations, Gaza Marine) could have been launched with public investment funding irrespective of progress in negotiations.

A higher proportion of development expenditures have been financed from PNA resources, becoming an additional burden on limited recurrent revenues and grants. Two major categories of development projects do not benefit from external financing and claim an increasing share of domestic resources: a) community projects, emanating from the Fayyad government drive since 2009 to revive rural areas and b) Various government expenses including the shift from rented premises for government ministries to the construction of government owned buildings.

The downside of loading up development expenditure with recurrent expenses has been the emergence of a growing financing gap on the development front, averaging NIS 267 million annually over the last three years, adding further payment arrears to the private sector (table 4).

3.4 Financial management of development

Both actual development expenditures and financing stand in sharp contrast to the three year plans emanating from MoPAD, starting with the Medium Term development Plan MTDP 2005-07; PRDP (2008-10) and followed by the National Development Plan NDP 2011-2013 and the latest Palestinian National Development Plan PDP 2014-16. Looking at both the PRDP (2008-10) and the NDP (2011-13) is illustrative, since one can compare plan projections with actual outcomes.

Table 5. Development Plans under the *PRDP (2008-10)* and the PNDP (2011-13), Budget allocations and actual expenditures in millions of US dollars

	2008	*2009*	*2010*	2011	2012	2013
Plan projections	*427*	*550*	*667*	**500**	**873**	**1095**
Budget entry	*492*	*400*	*450*	**470**	**350**	**350**
Actual expenditure	*215*	*260*	*299*	**370**	**243**	**249**[52]

Source: MoPAD. PRDP entries in italics and PNDP in bold; MoF budgets

The first observation worth noting is that development expenditure projections in the plans were typically based on optimistic assumptions with respect to the peace process and a resulting economic upsurge in Palestine. This may have been appropriate in for the PRDP in the wake of the Annapolis meetings in November 2007 and the Paris pledging Conference (December 2007), but not in the case

[52] The monthly fiscal reports from MoF list a total of $ 171 million for 2013 financed by the PNA. Table 11 lists all the projects financed by the PNA amounting to NIS 264 million ($ 73 million)

of the PNDP, when the Israeli political stance did not appear to support a two state solution to the Israeli /Palestinian conflict. In any case, development-spending projections in both plans were unrealistically high. For 2011, the PNDP scaled back development expenditure, with the knowledge that actual expenditure in 2010 was much lower than the PRDP projection (NIS 299 million as opposed to NIS 667 million in the PRDP). Yet, for the subsequent two years unrealistic projections were made as well.

The second observation is that there has been little relationship between the annual Budget, the Plan and actual spending. Until 2014, the annual Budget entered an amount for development expenditure, but it was merely an entry in line with previous years, and not an allocation of resources. The 2014 Budget, in a major qualitative advance in PFM, has entered for every line ministry and agencies their programs and objectives. Each program provides a breakdown of expenses, including minor capital spending. However while on-going and proposed development projects are listed, there are no budgetary allocations attached to them. Project funding by donors, which is not channelled through the budget, have little relation with the Budget entry. Development priorities, as stated in the plan, were not translated into annual budget expenditures and expected sources of funding, distinguishing between external and Treasury resources.

The third observation is that actual development spending channelled through the budget fell far short of either plan projections or budget entries, without any clear relation with plan priorities. Much of the spending has been on on going projects, judicial courts in various districts, security installations, and some infrastructure carried out by donors directly, with some local counterpart[53]. Over the past three years, some recurrent expenditure have been entered under the development label. For instance, in 2013, NIS 264 million were spent on development projects from Treasury resources. During the first nine months of 2014, the largest items were NIS 36 million (out of NIS 230 million) was for “President’s plane expenses”. Another item was the “support of refugee camps in the West Bank” for NIS 6.5 million.

Two lessons can be drawn from this experience: a) With monthly struggles to make good on salary payments and the accumulation of large private sector arrears, drawing on meagre recurrent resources to finance development projects, may not be the best allocation of resources. b) The trend in development expenditures has been declining sharply particularly in real terms. When spending on security, governance and social sectors is taken out, very little public investment in infrastructure has taken place with the exception of road network rehabilitation and four electrical substations in the northern West Bank.

[53] Most notably the rehabilitation of the road network in the Northern West Bank carried out by USAID in 2012-13.

Yet the opposite should have happened: to offset the recessionary impact of recurrent deficit decline, development expenditure should have been raised at a higher rate than the reduction in the recurrent deficit[54].

[54] Unlike recurrent spending, heavily weighted in wages, development spending has a high import content which only stimulates the economy to the extent that it is associated with labor hiring and local material purchases. The multiplier effect on the economy is much higher for recurrent expenditures than for development.

4.

Impact of budget deficits and financing

4. Impact of budget deficits and financing

In a normal and sovereign economy, a 12% recurrent budget deficit would raise unsustainable pressures. This large public claim on resources would crowd out the private sector, raise non-traded goods prices; depreciate the currency causing a further increase in prices and raise interest rates through government borrowing and higher public debt. Higher interest rates and price instability would lower investment and retard economic growth. Tight monetary and fiscal policies would be required to bring down inflation, reduce the deficit and stabilize the exchange rate, all of which would reduce economic growth to its long-term trend.

But Palestine is neither a normal nor a sovereign economy. The NIS is the currency in use and there is neither monetary nor exchange rate policy. Israel and Palestine are both open economies. Price stability is being maintained by the Bank of Israel through its monetary policy and by the Israeli Ministry of Finance through its fiscal policy. Fluctuations in the Palestinian fiscal deficits are too small relative to the Israeli economy size to affect overall price developments[55].

A temporary surge in price may occur in Palestine through non-traded goods, as happened in 2009, but fundamentally, the Israeli CPI sets the norm for Palestinian prices[56]. Moreover, due to Israeli economic restrictions and resulting low economic growth, Palestine has large excess capacity, unutilized resources, and high unemployment. There is no crowding out of the private sector, and in fact, as was discussed above (section 3.3), the budget deficit has been the major engine of growth in the economy. It provides a fiscal stimulus to economic activity and, in the context of the Israeli restrictions on private investment it was highly beneficial to economic growth. However, what makes the recurrent deficit unsustainable in Palestine is the inability to finance it in an orderly manner, beyond available external assistance and bank borrowing within prudential norms.

4.1 Erosion of public financial management and the role of the donor community

Notwithstanding the positive effect, which the budget deficit has on economic growth in Palestine, fiscal policy has succeeded in reducing the recurrent budget deficit by half, from 24% of GDP in 2007 to 12% of GDP in 2014, a major fiscal adjustment by any standard.

The donor community has recognized that most of this fiscal deficit is due to the suppression of economic growth under Israeli economic restrictions and a much lower level of public revenue than what would have been the case under a normal growth performance. In partial compensation the

[55] If the Palestinian budget deficit doubled from 11 to 22% of GDP, this increase in aggregate demand by NIS 5 billion would be insignificant in terms of Israel's GDP ($ 290 billion) and would have no impact on the Palestinian or Israeli price level

[56] This is a major advantage for Palestine allowing greater flexibility in fiscal policy. On the other hand, not having a currency and exchange rate could be viewed as a disadvantage. For instance the NIS has appreciated by 20% since 2000 (in purchasing power terms) reducing export competitiveness. Not having an exchange rate inhibits Palestinian policy makers from taking corrective action.

donor community has provided substantial budget support since 2000 exceeding $ 12 billion. Nevertheless, external budget support fell by more than half since 2007-09, from 18 % of GDP in 2009 to 8 % of GDP in 2014[57]. Yet the donor community, and particularly the IFIs, which monitors public finance and growth performance, have not recognized in any of their AHLC reports, the negative impact of lower fiscal deficits and lower budget support on economic growth under existing economic constraints in Palestine. Nor have they recognized that driving fiscal deficits down without offsetting increase in alternative spending such as private and public investment would not only reduce economic growth but also bring down government revenue, triggering a downward spiral of lower growth and lower revenues, making it even harder to reduce budget deficits further.

PNA budgets only partially adjusted to the sharp decline in external financial support due to an inadequate response in three areas: a) while policy actions did reduce the wage bill they did not address other expenditure issues or raise revenue significantly. b) Inadequacies in PFM which projected unrealistic growth rates, exaggerated budget revenues and understated rises in expenditure and c) a donor community which, while witnessing the deterioration in public finance, did not press for corrective action in cooperation with the PNA to realign recurrent budget deficits with available external financing and availability of domestic borrowing. There was no effective conditionality-governing donor financing of recurrent budget deficits while ensuring that appropriate fiscal reforms and public financial policies are formulated and executed. Except for 2010, actual fiscal deficits exceeded budgeted deficits by substantial margins, increasing over time. The excesses went from about NIS 500 million in 2009-10 to over NIS 1 billion in 2012-13. The actual deficit in 2012 was 42% higher than the budgeted deficit but MoF requested a supplementary budget of $ 250 million to repay private sector arrears. However, in 2013 the actual deficit was 46% higher than budgeted and in 2014, the excess in the actual deficit declined to 38%, but only because of the unexpected windfall of clearance revenue from Gaza of NIS 786 million. Private sector arrears accumulated to NIS 1.38 billion, including NIS 650 million to private hospitals[58]. On the other hand, there was a NIS 1 billion of arrear repayment to the private sector in 2014.

The cumulative excess in budget execution over budget allocations, from 2007 to 2014 amounted to $ 1.7 billion, or $ 212 million per year[59]. The World Bank Public Expenditure Financial Accountability (PEFA) stated: "Systemic weaknesses in budget preparation, budget execution and accounting/reporting were revealed"[60]. The large divergences between budgeted deficits and actual

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[57] 2008 was an exceptional year with external budget support at $ 1.76 billion or 28% of GDP, partly to pay salary arrears. 2007 and 2009 were normal years, when assistance when assistance amounted to 19.5 and 20.0% of GDP respectively. Budget support for 2012 and 2013 was smoothed out by restoring in 2012 $ 150 million from the US, which was delayed due to Congressional action, and disbursed in 2013.

[58] Private sector arrears include those incurred on purchases of goods and services; tax refunds; minor capital expenditures; interest on domestic debt; and development expenditures. MoF monthly reports for 2014

[59] Based on MoF budgets and monthly fiscal reports.

47 World Bank, PEFA, June 2013

outcomes are not the result of inadequate capacity in MoF or unforeseen events. The Budget department is highly competent and backed up by a macro/fiscal unit (MFU) which provides a robust medium term macro fiscal framework and accurate forecasts for economic growth, revenues and expenditure; monthly MoF reports provide full accounts on budget execution. Rather, it is a matter of implicit policy. Pressures to reduce the fiscal deficit from the one recorded in the previous year, without taking the necessary policy actions, inevitably lead to overstating revenue forecasts and downplaying expenditure increase. Nor are there systematic attempts to deal with payment arrears. Instead of making an explicit appropriation in the Budget for repayment of arrears (which would increase the deficit), arrears were ignored or relegated to a footnote[61]. In a positive change, the 2015 emergency budget entered an explicit provision for repayment of private sector arrears ($50-100 million), as "negative financing".

Table 6: PNA recurrent fiscal deficit and external budget support (In NIS million unless specified)

	2007	2008	2009	2010	2011	2012	2013	2014
Budgeted recurrent deficit	5572	4811	5800	4723	4009	3621	3885	4605
Actual recurrent deficit	5527	4859	6272	4447	4576	5136	5693	5455
Excess in actual deficit over budgeted deficit	45	48	472	-276	567	1515	1808	850
External budget support	4149	4818	5261	4275	3678	3662	3977	3677
External financing shortfall with respect to budgeted deficit	1423	-7	539	448	331	-41	-92	1058
Development financing shortfall	-	--	118	627	720	336	308	175
Total Shortfall with respect to the actual deficit	1423	--	1274	545	2381	2239	1716	1025
Total shortfall with respect to the actual deficit USD	*347*		*327*	*146*	*665*	*582*	*264*	*287*
Domestic bank financing to the PNA			691	363	334	490	-203	67
Accumulation of private payment arrears			250	179	930	737	1,200	1,382

Source: MoF monthly fiscal reports

Considering that the international community has been scrutinizing PNA budgetary execution and financial management since 1995, and has been reporting its findings at the semi-annual gatherings of the AHLC, two major issues arise: a) Since yearly PNA budgets have been discussed with the authorities

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[60] World Bank: West Bank and Gaza: Public Expenditure and Financial Accountability; June 17, 2013; p3
[61] In the 2014 Budget, the main table projecting Budget aggregates states in a footnote that the accumulation of (private sector) arrears in 2013 carried over into 2014 amounted to about $ 555 million. "These would be addressed in case additional revenues or additional financing sources were to occur"; see the 2014 General Budget, MoF, p18. Under existing financial stress, when it is officially acknowledged that a financing gap of $ 350 million is likely to emerge in 2014, such a footnote may appear disingenuous. By contrast, one donor (USAID) earmarked $ 100 million out of its budget support for the repayment of private sector arrears.

and submitted at AHLC meetings, with a request for budget support and an implicit approval by donors, why hasn't aid coordination ensured that external financing covers projected deficits? b) Given the yearly excess of actual deficits over budgeted deficits why hasn't the donor community taken concerted action in cooperation with the PNA to adopt corrective reforms in order to reduce budget deficits while firmly committing to its financing?

4.2 Budget deficit financing and the public debt

While the fiscal deficit served the economy well by providing a substantial stimulus to economic activity, the PNA quickly ran into financing problems in the face of declining external assistance. It build up a substantial public debt which amounted by end 2014 to $ 4.8 billion or 38% of GDP. This is a relatively modest public debt (below international prudential standards, set at an upper limit of 60% by the Maastricht Treaty), although lack of market access does not enable Palestine to increase this debt significantly.

Borrowing abroad would have been both difficult and inappropriate from a policy standpoint because of lack of fiscal sustainability. Interest rates would have been high even under some lender guarantees[62]. External public debt at $ 1.1 billion end of 2013 has been stable for several years and highly concessional[63].

Table 7. Palestine Public Debt as of end 2014 in US dollars billions:

External		1.10
▫ Debt to Arab countries		0.62
▫ International Institutions	0.35	
▫ Bilateral loans	0.12	
Domestic		3.68
▫ Bank loans and advances		1.02
▫ Public Institutions		0.32
▫ Arrears to private sector		0.55
▫ Arrears to the pension fund	1.12	
▫ Debt to IEC		0.51

[62] Gulf countries could buy some certificates of deposit in the PMA as they have done in the case of Jordan and Lebanon.

[63] Arab financing provided in 2001-03 to alleviate the withholding by Israel of clearance revenue is considered by the PNA to be a grant but in terms of the Islamic Bank accounting procedures it is considered a loan.

▪ Debt to GoI (clearance advances)[64]	0.16	
Total public debt		4.78

Source: MoF monthly reports table 8-a

Debt to international institutions is mostly due to the World Bank (IDA) and there are very few bilateral loans, mostly to Spain and Italy.

With little option of borrowing abroad the PNA turned to the domestic banking system. Reliance on short term bank loans and overdrafts for domestic financing reached $1.2 billion in 2012, and with some fluctuations remained at that level till end 2014 ($ 1.24 billion)[65]. Adding on loans to PNA employees of about $ 800 million brings banks' exposure to the PNA to about $ 2 billion, which amounts to 41% of banks portfolio and constitutes a substantial sovereign risk. However the Capital Adequacy Ratio for all banks in 2014 is 18%, which is double the recommended CAR under Basle III. An alternative possibility to bank loans, which has been considered, was to issue Treasury bonds to banks. This would help in restructuring PNA debt to banks and extend its maturity profile but it would not diversify banks portfolio of assets. Selling them to the public in the absence of fiscal sustainability would be problematic, relegating the bonds to "junk" status with high interest rates.

Other sources of financing are more problematic and less transparent, resulting in periodic crises and tensions with creditors. Payment arrears to Israel Electric Company (IEC) of about $ 510 million (including debt by the Jerusalem Electricity Company (JEDCO) to IEC) due to the accumulation of non-payment of electricity bills by municipalities[66] are a recurrent charge to MoF but has not been included in expenditure commitments. Despite the declining fiscal deficits, financing gaps have been persistent since 2010, forcing the Palestinian Authority to build up payment arrears to the private sector, accumulating liabilities to the Pension Fund and payment arrears to Palestinian public institutions such as universities and hospitals. Arrears increased from 3% of the operational budget in 2010 to 19% in 2012 and 18% in 2014. Private sector arrears at the beginning of 2014 were estimated at $ 555 million with a net accumulation during the year of about $ 100 million[67].

The management of arrears by MoF has been damaging to the Palestinian economy and to public financial management. It is credit forced upon the private sector creating uncertainty and inhibiting investment by suppliers, with their funds tied up as credit. Financing the budget through payment arrears is not planned, but used as a residual financing. This financing may become open ended, with loss of expenditure control.

[64] Statement from GoI, Ministry of Finance at AHLC "Tax clearance Transfers to the Palestinian Authority" March 17, 2013
[65] PMA, distribution of facilities
[66] The Gaza electricity bill (about NIS 40 million per month) is paid fully to IEC through deductions from clearance revenue
[67] MoF; the 2014 National Budget, p8 PEFA, p16, June 2013

5.

Structural weaknesses in Palestinian public finance

The time profile of arrears is not known but bills remain unpaid for two to three years. Repayment of arrears is not systematic but carried out on an *ad hoc* basis as a result of pressures by suppliers to stop deliveries and pressures by contractors to stop construction. Favouritism and interpersonal relations cannot be ruled out in a system which is opaque and where accountability is lacking. Budgets have not put in an appropriation for repayments of arrears, even though every budget inherits a large stock of arrears from the previous year. Exceptionally, in 2012, MoF issued a $ 250 million supplementary budget to repay private sector arrears by borrowing from banks. By contrast, no supplementary budgets were requested in either 2013 or 2014. However, as mentioned above, the 2015 budget does include a provision for private sector arrear repayment.

Arrears are being repaid throughout the year, without budgetary appropriation, drawing on current resources. This upsets budget execution and cash management and inevitably results in new arrears. When a supplier is not being paid he has to obtain a loan from his bank (against receivables) and has to pay interest. He will then pass on the expenses he incurs due to payment delays into higher prices for his future deliveries. Hence, reducing PNA bank debt will reduce public expenditures through savings in interest cost. However, while interest charges may decline, costs of goods and services will go up to make up for higher suppliers costs associated with payment arrears. Therefore, public expenditure may end up being higher than if interest charges were fully paid on higher bank debt.

To summarize this discussion, the recurrent fiscal deficit in the context of economic restrictions imposed by Israel has been a stimulant to the economy, in the absence of alternative sources of growth. Had the budget deficit been in the internationally acceptable range of 3% of GDP, growth of the Palestinian economy would have been in negative territory since 2007. The perpetuation of unfinanced budget gaps, lack of fiscal policy initiatives by the PNA in the face of declining external assistance, and the lack of effective oversight by the by the donor community towards corrective action, has been detrimental to PNA credibility and fiscal sustainability. And finally, MoF reliance on the accumulation of private sector arrears as a default option in financing its deficits, with the dampening effect on private sector economic activity and the lack of transparency and accountability which it entails, has dampened private sector investment and economic growth.

5. Structural weaknesses in Palestinian public finance

To understand developments in Palestinian public finance, it is essential to focus on the underlying structural factors. On the revenue side, the first set of impediments stems from the impact of the Israeli economic restrictions, while the second set of factors pertains to structural weaknesses in the Palestinian tax system. On the expenditure side, service needs of a rapidly expanding population, coupled with the need to manage a socio/political environment associated with high unemployment and poverty, have been driving public spending.

5.1 Impact of economic restrictions on public revenues

Foremost among public revenue determinants, are the restrictions on economic activities imposed by Israel in the West Bank and Gaza as discussed in section 2.1 coupled with the fragmentation of Palestinian territory which have undermined Palestinian private investment and growth, resulting in much lower public revenue than would have been the case otherwise.

Restrictions imposed on movements of Palestinian labour to Israel, on Palestinian exports into Israel (particularly border trade which thrived before the build up of the separation wall) and the "myriad of administrative measures which curtailed Palestinian development, prevented local Palestinian entrepreneurs from competing with Israeli ones, and further contributed to the economic asymmetry between the two sides"[68]. The siege on Gaza and restrictions on its imports, exports and labour movements have also been a major violation by Israel of the Paris Protocol, but Gaza has also become a major structural issue in Palestinian public finance (see below).

Since Israel does not allow Palestinian tax authorities to go to "Area C", tax collection and enforcement in "Area C" cannot take place. Moreover Israeli companies which are operating in "Area C" as "permanent establishment" such as bank branches[69], cell phone operators, gas stations and industrial establishments, should be paying income tax on the profits reaped from their operations as mandated by OECD and EU best practices. While the PP did not explicitly acknowledge this particular Israeli responsibility, there is unwillingness on the Israeli side to pursue these issues. Nor has the international community raised this issue with the Israeli side.

Another significant factor which further reduced public revenue has been Israel's hegemony in its economic relations with Palestine. In particular, it has been implementing the Paris Protocol in line with its own political and economic agenda, while denying the Palestinian side the ability to fully implement its clauses. Nor has the Palestinian side benefited from due process or arbitration in pressing its claims, as the Joint Economic Committee, dominated by Israel, remained largely ineffective, lacking up an impartial arbitration mechanism.

[68] The Aix Group: Twenty Years after Oslo and the Paris Protocol, June 2013
[69] There are 14 branches of Israeli banks in West Bank settlements.

As mentioned above, clearance revenue account for 66% of total Palestinian public revenue and are governed by the Unified Invoice system[70]. Three major sources of revenue leakage in favour of the Israeli Treasury have been identified in the implementation of the system and estimated by MoF at about $ 280 million annually[71]:

a) *Custom duties on indirect imports*. To bypass security delays at Israeli ports, many Palestinian traders prefer to import indirectly from Israeli wholesalers, against a commission payment. While the VAT on these goods is remitted to the PNA against invoices, customs duties are not[72];

b) *VAT invoices.* Many Palestinian importers do not surrender their VAT invoices to MoF either because they are not registered with the tax authorities or for fear that a linkage will be established with their income tax returns. Israeli authorities who hold copies of these invoices have not been willing to share this information.

c) *Undervaluation of direct imports.* Palestinian direct imports are cleared at Israeli ports after security checks and against the importer's custom declaration. Israeli customs authorities do not review these declarations for potential undervaluation. Because the Palestinian MoF is not allowed to maintain a customs presence at Israeli ports and border crossings (mostly in Area C), Palestinian importers get away with substantial underreporting of their import value. These leakages should have been addressed within the Joint Economic Committee (JEC), as provided by the Paris Protocol, but the Committee did not meet during 2000-08, and when some meetings did take place in 2013-14, the Israeli side did not respond to MoF concerns.

There are other leakages of revenue, which need to be settled with GoI:

Taxes, pensions and medical insurance of Palestinian workers, which have accumulated to NIS 2.5 billion, and which should be transferred to the PA, have also been withheld on a regular basis since 1994. GoI claims that they will withhold these funds until the PNA establishes a social security system and universal old age pension. However, pending these PNA reforms, these taxes should have been held in a trust Fund under independent management with annual earnings.

The equalization levy, which is a clearing arrangement with respect to social-security taxes that were levied on wages of Palestinians working in Israel in order to equalize the cost of their employment with that of Israeli workers, has also been withheld. These equalization levies that are collected by GoI are

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[70] A Palestinian trader importing from Israel receives a I invoice and an Israeli trader importing from Palestine receives a P invoice for VAT charges. These are cleared in the monthly clearance sessions. A major implication of this system is that if an invoice is not surrendered, payment is not transferred.

[71] UNCTAD recently estimated these leakages at $ 300 million. UNCTAD September 5, 2014

[72] This issue has been raised with the Israeli authorities by the PNA and the European Union since the Oslo period, without any positive response. The same issue arose between South Africa and neighboring states belonging to the Southern Africa Customs Union.(Lesotho, Swaziland, Botswana and Namibia) where such leakage has been estimated through a macroeconomic formula and distributed to the SACU countries. Veronique Kessler: Palestine's external trade performance, March 1999.

supposed to be sent to the PA in order to provide social benefits or welfare services to these workers. However, Israel has been withholding these fees since 2000, which accumulated to NIS 650 million till the end of 2013[73].

Another structural flaw in the implementation of Clearance Revenue under the PP, is Israel's prerogative to deduct charges owed by the PNA on electricity, water, sewage and hospital referrals. These deductions are quite large, typically about NIS 100 million monthly from revenues of about NIS 500 million without vetting these charges with the Palestinian side[74]. In November 2012 the entire clearance revenue was deducted by Israel (NIS 467 million to repay an electricity debt to IEC and JEDCO). This has made cash management by the PNA Treasury particularly difficult, since the size of the deduction is volatile and is not known in advance.

5.2 Structural weaknesses in the domestic tax structure

Unlike clearance revenues, PNA domestic revenues are much lower than their potential due to five structural weaknesses:

a) Regressivety of the tax system

The very low revenue ratio for income taxes in Palestine (8% of revenue and 1.7% of GDP) and the high ratio of revenue from indirect taxes (92%) makes the Palestinian tax system acutely regressive. A family living on the minimum wage (NIS 1,450 per month or $ 370) is paying 18-16% on everything they consume (except for fruits and vegetables) including basic foods such as milk, bread, eggs, and meat, while the upper income groups pay a much smaller share of their income on consumption taxes[75]. This regressive feature of the Palestinian tax system reduces policy maker's flexibility in raising indirect tax rates or in lowering income tax rates. In Israel and Jordan about half of tax revenue emanate from income taxes. In Morocco income tax contributes, 52%; Tunisia 48%, Turkey 51%. The Palestinian government may want to lower this regressivety, and contribute in reducing the recurrent deficit, by raising the corporate income tax rate from 20% to 25%.

b) Narrow tax base[76].

It is estimated that 70-80 % of domestic taxes are generated by less than 5% of taxpayers, mostly included in the Large Taxpayer Unit of about 300 companies.

[73] IEC sale price of electricity sold to the PNA includes VAT. Yet, GoI has not transferred NIS 440 million accumulated between 1997 and 2002.

[74] . Israel has provided the PNA with advance clearance revenues when the PNA was faced with a liquidity crisis.

[75] In Israel, which has roughly the same indirect taxes as Palestine but much higher income taxes, the burden of indirect taxes on the income of the lowest income decile is 44.2% while the burden of indirect taxes on the highest income decile is 11.6%. Knesset Center for Information and Research, July 2011.

[76] Much of the data provided for the income tax and VAT is drawn from the MoF Revenue Mobilization Strategy Power Point Presentation at LACC March 2014

The income tax has been investor friendly, typically with three rates for individuals (5; 10; 15) and a low rate for corporations (15%). However, it has been undermined by an excessively generous 2011 Investment Promotion Law, providing 7-9 years of tax holidays for qualifying investments. This exceeds the investment promotion provided by neighbouring countries and has narrowed its base considerably with revenue foregone estimated at NIS 97 million[77]. In 2012, the income tax law was changed, providing for a much larger threshold for the individual tax and raising the upper tax rate to 20% for both individuals and corporations[78]. It is estimated that the increase in the top marginal rate from 15% to 20% yielded an additional $ 18 million in revenues. In 2014, income taxes on profits emanating from bank lending to SMEs has been reduced from 20% to 10%. This raises an issue of enforcement, since tax officials would find it difficult to distinguish between profits on loans to large enterprises and small ones. The net result may be that the effective tax rate for banks profits may slide down from 20% to 10%.

Income tax revenue in Palestine is far less than in neighbouring countries[79] and far less than its potential collection, considering that area C cannot be taxed and that Gaza has been exempted since 2007.

- It is estimated that 80% of potential income taxpayers do not pay income tax. The 20% who are registered pay for everyone else.
- Of the 7835 companies registered with the income tax only 6500 file tax returns (83%).
- Of the 131,000 individuals registered with the income tax, only 86,425 are filing returns (66%)[80]
- Under the Investment Promotion law 590 corporations have been exempted of the income tax. Tax revenue foregone annually under this law is estimated at NIS 100 million[81].
- If tax payment is effected by end February an 8% discount is provided; if paid by March 6%. Under international standards such discounts should not be provided. Rather penalties should be assessed if payments are late.

VAT. Revenues from the domestic VAT estimated at NIS 840 million in 2013 account for only 2% of GDP even though the rate is relatively high (16%). Dividing its revenues by the number of registered and active taxpayers (25,000) the average VAT payment amounts to NIS 336. This extremely low

[77] IMF Technical memorandum on Investment Tax incentives Krelove & Swistak, August 2013
[78] An attempt by the Fayyad government to raise to upper marginal rates to 35% faced a strong backlash by the business community and was rescinded
[79] Egypt 7.7 %; Cyprus 10.4%; Israel 9.8%; Jordan 4.7%; Lebanon 3.4%; Malta 13,2%; Morocco 9.6%; Syria 5.7%; and Tunisia 8.7%.; Turkey 5.9%. All data for 2010. Following the Arab Spring these ratios deteriorated substantially in Egypt, Tunisia and Lebanon
[80] Of the 5000 lawyers operating in Palestine only 200 are registered with the income tax department

[81] Tax liabilities in 2012 of the 55 companies would have amounted to NIS 70 million.

payment indicates large-scale tax avoidance (estimated at 70% by MoF)[82] and undervaluation of gross revenues by registered taxpayers. There is a large potential to double its GDP share of revenue by bringing it closer to the VAT/GDP share remitted through the clearance mechanism (4.7%).

Property tax. About 70 municipalities, out of 107 and 376 rural councils, are registered in the property tax but only 52% contribute to it. It is collected by MoF and 90 % is transferred back to the municipalities. There has been substantial progress in collecting property taxes, which increased from $ 17 million in 2008 to $ 59 million[83] in 2013. However, the potential for higher collections is substantial, given the property boom that has taken place over the last few years.

c) Low compliance

Low compliance and undervaluation of income, revenue and import value are pervasive in the system. Enforcement is low and tax payments are mostly negotiated with taxpayers. Penalties are rarely levied. Contested files are held for several years for resolution and when a settlement is achieved deep discounts are provided.

Lack of adequate record keeping and a large informal economy have stymied tax administration in strengthening compliance. At the same time lack of tools and procedures to identify unregistered tax payers, have slowed down tax administration efforts at improving compliance. Risk-based verification programs to detect underreporting and low compliance have only been partially utilized. In addition, inadequate computer coverage of all taxpayers and their liability, coupled with rudimentary cross checking taxpayers for income tax and VAT have been identified by MoF as major factors behind low compliance. Information networks among government agencies and exchange of information between PNA agencies, and chambers of commerce and industry are virtually non-existent

d) Under-pricing of petroleum products.

While the PP specifies that the Palestinian gasoline price cannot be lower that the Israeli one by more than 15%, no such restriction has been articulated for diesel fuel prices. Between April and September 2013 diesel fuel prices in the West Bank were under-priced on the average by 26% in relation to purchase prices from Israeli suppliers[84]. In practice, this policy amounted to giving back to the Palestinian consumer NIS 2 per litre out of the NIS 3 per litre of excise taxes, which the PNA collects during clearance sessions from the Israeli authorities on their sales of fuel products to the PNA[85]. Losses have been incurred on other petroleum products, mostly gasoline which is priced about 12% lower than Israeli prices.

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[82] It is estimated that 40,000 businesses are not registered with the VAT and 45,000 which are registered are not active
[83] MoF Property Tax administration.
[84] See IMF technical memorandum
[85] Diesel fuel in Palestine is not subsidized in the sense that its retail prices are higher than international prices. Rather it is taxed less than it is in Israel.

While the price differential on diesel fuel has been narrowed to 17% by end December 2014, this tax refund cost the PNA NIS 720 million in 2013 about ($ 200 million) and NIS 524 ($ 147 million) in 2014 slightly above Budget appropriations[86]. PNA policy makers were justifying this policy by claiming that they would gain in volume what they lost in excise taxes. However, there is no evidence that this was the case. In the short run, fuel products are price inelastic and possibilities of expanding market share through smuggling are limited by the separation barrier and crossing points. In addition, PNA officials felt that this tax refund would lower the cost structure of the Palestinian economy, and improve competitiveness and income distribution. However, it remains to be seen whether both of these objectives can be achieved more efficiently through alternative policies. Reducing the price differential from 17% to 5% can yield NIS 400 million annually.

e) Static public service charges

Fees and charges for licenses, permits and registrations have been fixed in value and left unchanged for over a decade. The average annual payment for a professional license today is NIS 200, a lower payment than administrative costs. In most countries these charges tend to be inelastic with respect to GDP unless yearly revisions are put in place. In 2005 they accounted for 18% of MoF revenue and 5.3% of GDP. Because these charges have not been adjusted with inflation their share in revenue in 2014 had declined to 10% of revenue and 2% of GDP. This is a dramatic 3.5 percentage points of GDP (NIS 1.4 billion) loss of a major source of revenue. MoF has recently revised fees and charges and plans to increase them with the 2015 Budget. Raising these charges by one third could yield NIS 300 million.

The revenue strategy adopted at the beginning of 2014, was rightly focused on broadening the tax base and raising tax enforcement and compliance. A tax registration drive has been on going in both income tax and domestic VAT, although this is an arduous endeavour which will only produce results in the medium term. On the income tax, the recent amendment to the Investment Promotion Law should limit the scope for tax exemptions in coming years.

5.3 Structural weaknesses in public expenditure

There are three structural weaknesses in public expenditure which partly explain why expenditure management has been relatively ineffective in reducing the fiscal deficit: i) the wage bill; ii) net lending to municipalities and iii) expenditure policy

[86] In December 2014 diesel and gasoline prices in the West Bank were NIS 6:30 and 6:80 respectively while in Jerusalem gas stations they were NIS 7.58 and 7.51 respectively

a) The wage bill

Expenditure on Palestinian government employment accounted for 50% of total recurrent expenditures in 2014 and 16.1 % of GDP. This is a substantial decline from the GDP ratio recorded in 2005 and 2010 (22 and 18 % of GDP respectively), but it is much larger than wage bills in neighbouring countries[87]. Increases in PNA employment and in the average wage are the two components explaining the evolution of the wage bill.

Employment: The increase in PNA employment has been restrained over the last few years, particularly since 2010. Yearly increases in employment have been limited to 3000 employees and in the 2013 Budget new hiring was reduced to 2007 employees, slightly higher than the number of retirees, establishing a net freeze in recruitment. (Table 8 below). Similar restraint was exercised in 2014. By end September 2014 the total number of employees was 154,935, including 65,286 in security.

Salary: Restrain in salary increases has been more difficult due to pressures from government employees and labour unions. The average annual salary increase for public employment has been 5% in 2011, 6% in 2012 and 4% in 2013[88]. However, in 2014 the wage bill increased by 6% over the2013 level even though there was hardly any increase in personnel and the cost of living increase was only 1.73%. A look back at average wages and salary increases over the years, demonstrates that government employees have consistently benefitted from wage increase, which have exceeded the cost of living increase.

Nevertheless, overall retrenchment in wage bill policy has been the single most important factor in reducing the recurrent deficit by lowering PNA expenditure from 34.5 % of GDP in 2010 to 32.4 % of GDP in 2014.

Table 8. PNA employment, wage bill, average wage, salary increases and rise in the cost of living

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
PNA employment (000)	122	125	129	133	151	167	144	143	148	150	153	154	154
PNA wage bill (NIS billions)	2.85	3.04	3.38	3.90	4.49	5.30	5.26	5.14	5.72	6.02	6.38	6.83	6.96
PNA monthly wage (NIS)	1950	2025	2183	2442	2475	2642	3042	2975	3225	3333	3475	3692	3775
Yearly increase in av. wage (%)		4.1	7.7	11.9	1.4	6.7	15.1	-2.3	8.3	3.6	4.1	6.2	2.4

[87] Egypt 6.6%; ; Jordan 15.6%; Lebanon 6.3%; Morocco 10.3%; Tunisia 10.5% and Syria 9.3%. Data for 2010, IMF, Government Finance Statistics.

[88] These are gross salaries, derived by dividing the wage bill by the number of employees. They include pension and health insurance contributions. Take home salaries are 15-20% lower. The exact average salary for 2013 is NIS 6.928 billion divided by 154,386 employees, or NIS 44,874 per year or NIS 3740 per month. Numbers for earlier years are approximate.

Salary increase (%)	--	--	15	6	22	--	--	7	4	4	5	6	4
Increase in cost of living	1.2	5.7	4.4	3.0	4.1	3.8	1.9	9.9	2.7	3.7	2.9	2.8	1.7

Source: Ministry of Finance, Payroll department, PCBS. Data verified Oct.21 2014.

b) Net Lending.

In 2013, the electricity subsidy (Net Lending) entered in the 2013 Budget was reduced to NIS 300 million from an actual outcome in 2012 of NIS 1.1 billion, without any specified or adopted measures to support this reduction[89]. The actual outcome turned out to be NIS 760 million. Undeterred by this budgetary lapse, the electricity subsidy was budgeted in 2014 at NIS 600 million, again, without any measures supporting this reduction. In 2014 the electricity subsidy amounted to NIS 1.7 billion (3.8% of GDP) including accumulated charges by IEC but not entered in the budget as a commitment. The fact that this electricity subsidy has risen in both 2013 and 2014 indicates that there has been a loss of control in managing it. It is estimated that non-payment of electricity charges amounts to 58% of the total IEC cost[90]

The Gaza monthly bill is being paid by the PNA to IEC (about NIS 480 million in 2013) through Israeli deductions from clearance revenue. In addition, payments are due by the PNA to the Gaza Electricity Generating Company as a capital return on investment ($ 2.5 million per month) whether the plant operates or not. At least the PNA is not paying for the fuel to operate the plant, which it did till mid-2013. Payments are also due to Egypt for the 12 MW it provides, although Egypt has been giving it back as a grant. All in all, the Gaza electricity bill is about NIS 600 million, mostly paid by the PNA.

There is a wide variation in West Bank municipalities' compliance in their electricity payments. Some like Qalqilya pay 91% of what is due, but others pay much less, like neighbouring Tul Karem (47%) or Hebron (42%)[91]. West Bank municipalities with low compliance claim that because the PNA has failed in remitting their share of transportation and property taxes, they have deducted these amounts owed to them by the PNA from their electricity bills. In this case, Net Lending has been overstated by the amount of electricity bill payments collected by municipalities and offset against tax payments due to them. A Special Government Committee has been established to implement remedial actions and monitor progress.

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[89] Net lending is measured by GoI deductions for electricity charges during the monthly clearance sessions. However, the deductions may be substantially lower than the actual charges as has occurred in 2013 and 2014. During these years there was an accumulation of charges with IEC of NIS 704 and NIS 716 respectively. These should have been entered as expenditure commitments in the 2013 and 2014 budgets (as was done in table 3) and as payment arrears.

[90] World Bank: Assessment and Action Plan to improve payments for Electricity Services in the Palestinian Territory. June 2014.

[91] Municipal lending Fund: Main Causes of Municipal Electricity Arrears and Expected Fiscal Impact of Transferring the Electricity Service December 12, 2008. World Bank

This has been an intractable issue, which requires strong action: Refugee camps which have been mostly exempted from paying electricity bills have set a bad example to neighbouring cities. This exemption should be waived and enforcement of payments through electricity cuts should be established. A matrix of cross arrears with the municipalities should be set up to clear the debts and transfer the collection mechanism to the electricity distribution companies, while fully remitting fees owed to municipalities. Improvements in MoF cash management described below should make these payments possible.

c) Expenditure policy

It was mentioned above that the Palestinian tax system was regressive, with 92% of tax revenue emanating from indirect taxes. But income redistribution through public policy towards the poorer segments of the population should be judged not only from the taxation angle but also from the composition of government expenditures. In Palestine, three clusters of expenditure stand out: education and health; transfers to the most vulnerable segments of the population and security. Table 9 provides some country comparisons for these clusters under the IMF's GFS classification. Two findings stand out: Palestine does quite well for education and health where their combined GDP shares exceed that of every other country, including Turkey and Israel. Comparing social protection may be misleading because countries have differing coverage. For instance, bread subsidies are included in Egypt but electricity subsidies are not included in Palestine. Nevertheless, Palestine spends about 5% of GDP on social protection, ahead of Tunisia, which is known to have an extensive social protection system.

The second finding is that "public order and safety" in Palestine, i.e. security, at 8.7% of GDP is more than double the GDP shares in other countries. It exceeds spending on education and health combined. When this spending is combined with the defense category in other countries, it still exceeds their spending, except for Jordan. While security in Palestine is critical in maintaining political stability and the rule of law, spending on security is disproportionate relative to other countries. It becomes a structural and distributional issue for Palestinian public finance, to the extent that it adds to the fiscal deficit and crowds out other expenditures[92].

[92] If the Palestinian GDP was not repressed by Israeli restrictions, all the shares in the table for Palestine would be lower. Nevertheless, the relative shares among expenditure would remain the same.

Table 9: Major public expenditure categories in GDP shares for 2012

	Palestine	Egypt	Jordan #	Israel	Tunisia #	Turkey
Education	5.3	3.6	3.7	5.2	5.8	4.1
Health	3.2	1.5	3.3	2.5	1.5	4.1
Social Protection	4.9	9.2	8.8	7.0	2.0	12.2
Public Order	8.7	1.8	4.1	1.5	2.5	1.9
Defense	---	1.7	4.8	6.1	1.5	1.5
Education and health	8.5	5.1	7.0	7.7	7.3	8.2

Data for Jordan and Tunisia is for 2011. Source: IMF GFS yearbook 2013 tables 7

6.

Reintegrating Gaza into the Palestinian Economy and public finance

6. Reintegrating Gaza into the Palestinian Economy and public finance

After the tightening of the siege on Gaza by both Israel and Egypt in 2013, and the inability of the D*e Facto* Government (DFG) to pay the salaries of its estimated 42,000 employees, Gaza's economy lost all viability and governance became unsustainable for lack of budgetary resources. This coupled with the failure of the Kerry peace process in April 2014, prompted Hamas and Fatah to seek an understanding, if not reconciliation. On April 23, 2014 Hamas and Fatah agreed to unify the two administrations and pave the way for elections to be held in 2015 (The Shati Agreement). On June 2nd, 2014 a Government of National Consensus (GNC) was formed, headed by Rami Al Hamdallah and 18 independent ministers.

The war between Gaza and Israel (July 8-August 26, 2014), caused massive casualties among Gaza's population and destruction of much of Gaza's housing and infrastructure. It made it clear to all parties (the donor community, the Palestinian leadership and GoI) that the status quo in Gaza was unsustainable. Gaza became an open-air prison with 70% of the population receiving food aid and reducing economic activity to local trade and services. The reconstruction/destruction cycle had to end through a fundamental lifting of the siege and change in Gaza's movement and access regime. On September 25, 2014, Hamas and Fatah signed an agreement to allow the PNA to operate in Gaza. When Hamas took over Gaza on June 14, 2007 the PNA had about 65,000 employees of whom 32,311 were civilians and 30,000 security personnel[93]. The DFG established its own administration and only those PNA employees pledging allegiance to that government were incorporated into the administration. PNA security personnel and a large segment of the civil service became unemployed l except for a number of teachers and health workers who were needed by the DFG, for lack of the required skills among their own employees. These employees were all paid full salaries although many of them took up part time jobs. Given the financial difficulties experienced by the PNA it is surprising that no efforts were made to secure some savings in the Gaza wage bill. One obvious approach would have been to pay lower salaries. The only measures taken by the PNA in 2013 were a postponement of the cost of living allowance (also applied to the West Bank) and elimination of supervisory allowances.

At the end of 2013, PNA cash expenses in Gaza were broken down as follows:

Table 11. PNA monthly cash expenses in Gaza in 2013 (NIS millions)

Salaries to military	138.0
Salaries to civilians	104.2
Allowances to prisoners	2.9
Assistance to Vulnerable families	15.7

[9393] MoF, payroll department

Social allowances	12.8
Local Gov. projects	0.5
Energy Auth. Projects	0.5
Water Auth. Projects	1.9
Electricity bill to IEC	40.0
Health referrals	16.0
Total	332.5

MoF, Budget department, November 2013

On an annual basis this amounts to NIS 4 billion or 34% of the PNA 2013 cash expenditures (NIS 11.7 billion). Revenue from Gaza increased to about 15% of total clearance revenue in 2014, or NIS 1.08 billion on an annual basis, leaving a recurrent Gaza deficit of NIS 2.6 billion.

The DFG budget was estimated in 2013 at about $ 800 million, about 57% of the PNA cash budget. The DFG employed 22,000 civilian employees, and about 7,000 under contract. It also employed about 16,000 security personnel. The monthly payroll for these employees was widely reported at $ 40 million, with an average monthly wage of NIS 2600[94]. Excluding wages, the remaining $ 320 million have been mostly spent on operational items and some transfers.

The main priority in Gaza in the fall of 2014 was to provide shelter to the 85,000 displaced people before winter weather sets in and to restore higher electricity and water availability. Integrating the two administrations and establishing good governance will be a major challenge and may take several months. Public institutions, such as the Gaza Electricity Distribution Company and universities will need to be “nationalized” under a unified government.

The second challenge will be to unify the fragmented justice system made up of Ottoman laws, British laws, Jordanian laws, Egyptian statutes, laws enacted by the PNA prior to 2007, Presidential decrees and laws enacted by DFG after 2007. Unifying these laws and addressing the status of applicable laws will take considerable time and effort.

The third challenge, and probably the most difficult one, will be to maintain law and order under one command structure. Harmonizing the police force and establishing a unified security and civil defense system will be essential for Gaza’s political and economic sustainability.

While the Gaza National Economic Recovery and Reconstruction Plan (NERRP) has allocated $ 183 million for rehabilitating government institutions which were damaged or destroyed, re-establishing a unified governance system will take additional resources to retrain the civil service and buy off redundant civilian and military

[94] See table 8. The net monthly wage for PNA employees would be around NIS 3340.

personnel and rationalize employment. A Follow-up Committee has been established to monitor the unification process.

a) Impact on expenditure

Employment

By end September 2014 there were 26,314 permanent PNA civilian employees in Gaza and 35,000 security personnel. The DFG had 20,000 permanent employees and 16,000 security personnel[95]. Absorbing 22,000 civilian employees into a unified civil service (for a total of 48,000 employees) would cost an additional $23 million per month. However, GNC operational needs in Gaza would not require more than 25,000 employees, creating a redundancy of 23,000 employees. Security employees could also be limited to 30,000, with a redundancy of 20,000.

There are two options in dealing with this redundancy, which might be considered by the GNC

- For PNA employees who have served at least 15 years of service early retirement at half salary could be offered. Employees with fewer years of service could be offered lower retirement benefits.
- DFG employees have served for seven years at most. Those over 50 years of age could be offered a lump sum for retiring from the service depending on age and years of service

To bring down public employment to affordable levels would require financing from the international community, as well as its strong leverage to establish governance and the rule of law.

This process would be greatly facilitated if the GNC assumes control of the crossing points and some key ministries. This would also enable reconstruction to move ahead on a broad front provided Israeli restrictions on movement and access are substantially lifted. This will create a surge of economic growth and additional jobs which some of the redundant public employees could fill.

Operational expenditures.

The GNC will have to assume all operational expenditures in Gaza, estimated by MoF at $ 20 million per month. In addition, the GNC is paying the electricity bill to the IEC of NIS 40 million per month, and health referrals (NIS 16 million), in addition to NIS 3 million on utilities.

Transfers.

[95] Both civilian administrations also had contractual employees but these employees do not have a claim on permanent employment and do not constitute a significant factor in merging the two administration

The DFG established a broad social network of private schools, social centres, charities and mosques. Most of these were funded by private donations and it is likely that this funding will be maintained. The PNA had funded large transfers to the most vulnerable groups and the unemployed through joint targeting conducted with the EU and the World Bank; in addition MoF estimates that another $ 8 million will be needed to cover transfers in the aftermath of massive dislocation and unemployment caused by the Gaza war. UNRWA and the World Food Program provide their own lines of social support.

On the positive side imports through Israel are expected to increase indirect tax revenue, which will alleviate to some extent the impact of higher expenditures. As mentioned above the Gaza fuel effect on clearance revenue has been estimated at NIS 786 million ($ 220 million) in 2014.

There may be additional import duties and VAT related to reconstruction material, machinery and equipment, but at least half of these imports, channelled through UN agencies and other donors would be tax exempt. The reconstruction effort itself will generate higher growth and higher consumption imports. Estimates of such revenue will have to await greater clarity on the pace of reconstruction, the extent of tax exemption and the pickup in economic growth. Nevertheless, it would be safe to assume that these imports may bring another $ 100 million in indirect taxes from Gaza in 2015. In addition, the income tax for Gaza may be reinstated, once the pace of reconstruction and economic growth picks up.

7.

Restoring fiscal sustainability and sound public financial management

7. Restoring fiscal sustainability and sound public financial management.

During 2015, the government will be facing major challenges. On the domestic front, it will need to manage an emergency budget based on a continued freeze of clearance revenues, which started in December 2014. Under the freeze only 77% of the wage bill would be disbursed, although it is not clear how long the government can maintain this policy, considering that bank financing may have reached its limit. Both operational expenditures and transfers would be reduced with external financing projected at only $ 800 million. Lower income among PNA employees will cause a downturn in economic activity and government revenues.

In Gaza it will need to implement the consensus agreements reached with DFG, starting with salary payments to its civilian employees, and move the Gaza relief and reconstruction forward at a faster pace than the very slow beginning since October 2014. Otherwise the GNC will fail.

Economically and financially the Palestinian government is likely to face stagnation in the West Bank, coupled with high expectations and rising frustrations in Gaza. Public revenue growth will be limited by subdued economic performance in the West Bank while expenditure will be saddled by immediate Gaza relief needs, which may not be funded from abroad. External assistance will be mostly focused on Gaza and there will be a substantial risk of shortfalls in budget support and the accumulation of private sector arrears. To regain private sector confidence and fiscal sustainability, it is essential for the government to deal effectively with arrears and adopt credible revenue and expenditure measures and improve PFM with adequate financial support from the donors and an improvement in the investment environment by GoI.

7.1 Public financial management.

There are three interrelated policy issues in PFM which need to be addressed simultaneously, 1) payment arrears: 2) budget formulation, reporting and execution; and 3) deficit financing.

Foremost among the measures needed to restore credibility to PFM would be a comprehensive accounting and systematic liquidation of all PNA payment arrears. A clear definition of payment arrears for all suppliers would be a starting point[96]. A number of steps may be envisaged:

- Estimate the full stock of arrears
    - Pension arrears can be readily established with the Pension Fund. These should be around $ 1 billion and should be dealt with within a Pension Fund reform

[96] A standard definition would be any bill which is over three months overdue.

   - Arrears to government institutions, including the six hospitals in East Jerusalem, universities, JEDCO, IEC, and other public institutions need to be estimated.
   - Estimating the stock of arrears to the private sector. A census of all outstanding bills overdue would be added to all the bills accumulated in line ministries. Since five line ministries are the recipients of 95% of procurement bills (Ministry of Health; Education; Public works; Interior; Local governments), this census should be easy to undertake.
- Establish a transparent payment system and elimination of future arrears.
   - The results of the arrear survey would be published and acknowledged to each supplier as a public debt. The time profile of arrears will be revealed.
   - All small amounts—say up to NIS 1 million, would be initially paid off.
   - Repayment of larger amounts would be scheduled, with the oldest bills paid first. This would eliminate any favouritism in payment procedures. If funding is not available, a partial payment would be made.
- Establish a fund to liquidate private sector arrears and preempt the emergence of new arrears with financial support from the donors.
   - Arrears would not be carried from one year to the next. A fund would be established to repay all private sector arrears
   - Since this would be a major PFM reform it should gain the support of the donor community.
   - If budget formulation and execution is carried out along the lines suggested below and if past arrears are not carried into the new budget year, no new arrears should be incurred. If unforeseen circumstances arise during the budget year, a supplementary budget with appropriate financing should be enacted so that new arrears can be liquidated within the Budget year.

The second major issue in PFM reform is budget formulation, budget management and reporting, budget execution and deficit financing

- Budget formulation and forecasts in Palestine benefit from a rich and consistent data set at MoF on revenues and expenditure, spanning a period of twenty years. The MFU, backed up by PCBS, produces a robust medium term growth framework. Expenditure classification between recurrent and development categories should strictly follow GFS standards.
- Budget execution would adhere to budgetary commitments and minimize manual overrides of the BISAN system. Monthly reporting on budget execution would highlight over-performance as well as shortcomings so as to elicit data based decision-making.

8.

Conclusion

- The annual development budget would be limited to on-going and new development projects included in the three year Plan, with an accurate forecast of expected disbursements and sources of financing. Projects directly financed by donors (outside the budget) should be reflected in the Budget, together with expected external financing disbursements[97].
- A resolution of payment arrears as discussed above, coupled with an objective and realistic budget formulation, in consultation with the donor community, should establish a budget deficit target, which can be fully financed. Financing provided by the donor community would be supplemented by domestic borrowing, including possible issuance of Treasury bonds within prudential norms.
- The approval by the international community of the government budget, under AHLC monitoring and consultation should also provide a firm commitment by the donors of the necessary budget support. Donors should coordinate their budget support to establish some predictability and reduce the volatility in disbursements.
- A budget deficit reduction, in the absence of alternative sources of economic growth, should be accompanied by an increase in public investment and development commitments to offset the negative impact on growth resulting from recurrent deficit reduction. At the same time, the international community should obtain GoI commitment to facilitate implementation of Palestinian investments in “area C” and in Gaza.

7.1 Deficit financing and the role of the international community.

The measures outlined above have two objectives: a) achieving fiscal sustainability and b) restoring sound public financial management.

Restoring fiscal sustainability entails adopting revenue and expenditure measures which would be sufficient to cover the financing gap between expected external budget support, available bank financing within prudential norms, and a realistic projection of the recurrent deficit. In 2014, total external financing received was about $ 1.24 billion while the overall budget deficit was $ 1.79 billion. The financing gap of $ 550 million is equivalent to 4.3 percentage points of GDP. Additional bank financing can only be marginal, considering the high bank exposure to PNA sovereign debt.

The role of the international community would be critical in supporting this fiscal and financial management reform. With the budget deficit set in consultation with the donors, both external budget

[97] A linkage needs to be established between DARP and BISAN. This may require harmonizing budget classification between the two systems.

support and development financing should be fully subscribed by the donor community, so that external financing shortfalls do not emerge. The international community can also use its aid as leverage in bringing about public employment retrenchment and good governance in Gaza[98]. Aid coordination will be essential in pinning down financing amounts and disbursement phasing. GoI commitment to facilitate implementation of infrastructure and development projects would also be critical.

The fiscal retrenchment outlined above in the recurrent budget, over a two to three year period, equivalent to 4.3 percentage points of GDP, would be a major withdrawal of fiscal stimulus from the economy. Unless it is compensated by equivalent private sector and public investment, it will dampen economic growth and set the economy back further into negative territory. In the absence of private sector investment, under the current political outlook, only matching increases in donor financed development spending would offset the negative impact on the economy of fiscal retrenchment. After many years of infrastructure neglect and de-development in Palestine, this would bring back a measure of physical capital accumulation. As always, it will remain dependent on Israeli facilitation. The international community should play a critical role in obtaining Israeli assistance in the implementation of these projects. In effect, fiscal and financial management reforms would entail a switch from government consumption to public investment, a position long advocated by the donor community.

[98] The World Bank Trust Fund monitors progress in institutional reforms and EU PEGASE is launching a "result oriented framework" with several criteria to monitor progress. However, neither of these instruments would be focused on achieving fiscal sustainability.

8. Conclusion

Over the past few years economic and political conditions in Palestine have deteriorated in a self-reinforcing downward spiral. Growth in the West Bank has declined to stagnation levels, and per capita income in Gaza today is lower than it was in 1994. Both public and private investment has fallen, and external official assistance as well as private transfers also declined. Prospects towards productive negotiations with Israel have receded and relations between the two sides seem to be worsening. Even the reunification process with Gaza and the reconstruction plan is fraught with uncertainty and faces major obstacles.

In this environment the Palestinian fiscal deficit has become the only engine of growth but it is also financially unsustainable. Its large unfinanced gap has burdened the private sector with payments arrears, further reducing private investment, raising uncertainty and destabilizing the economy. The recurrent deficit must be reduced to available legitimate sources of financing, but by doing so, it will also reduce economic growth. To resolve this contradiction, the Palestinian government, and the international community, may want to adopt a three pronged approach:

- The Palestinian government, in consultation with the international community, would undertake a comprehensive fiscal and financial management reform to raise revenues, reduce expenditures, and resolve the issue of payment arrears with the objective of reducing the recurrent fiscal deficit to the level of available external budget support and bank financing.
- To offset the negative impact on growth of reducing the recurrent fiscal deficit and in support of the Palestinian reform program, the donor community, through aid coordination, would commit to budget support levels consistent with the reform program, and with an increase in public investment and development projects, equivalent to the reduction in the recurrent deficit.
- The international community, in consultation with the Palestinian government, would identify a set of investment projects, which could be readily executed over the next two years with GoI facilitation. This would improve the investment climate and trigger a switch from fiscal deficit led growth to private sector driven growth.

This approach would achieve several objectives at once: addressing the structural issues in Palestinian public finance and reducing the recurrent budget deficits to available sources of financing; removing the uncertainty and volatility from external financing and strengthening the private sector by eliminating payment arrears and offsetting the negative impact of deficit reduction by an increase in public investments in critical infrastructure projects. However, the latter objective will require a substantial roll back of Israeli economic restrictions. While fiscal sustainability can be restored with the measures outlined above, regaining economic viability will require a paradigm shift in the Israeli approach to economic restrictions and a change in the economic environment, which would improve

private sector perceptions. This would trigger a large increase in both private and public investment, which can only happen with pro-active Israeli facilitation. At this very difficult juncture in the Palestinian political and economic conditions, such a strategy would go a long way in reversing the economic decline and restoring some degree of empowerment and optimism.

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